

# M&A UPDATE

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## **Cross-Border Structuring and Acquisition Financing**

by Richard Clark

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**CROSS-BORDER ACQUISITIONS** invariably involve some form of acquisition financing, whether debt or equity, and U.S. lenders and investors often ask Stikeman Elliott to identify the structuring and financing issues that are characteristic of U.S.-Canadian transactions. This article highlights major structuring and tax issues, together with a range of other significant Canadian legal considerations in this context.

## Structuring Issues

### Introduction

Finding the right structure depends on correctly assessing the situation and objectives of the U.S. lender/investor. Canadian counsel will therefore typically ask questions such as:

- Have you done a Canadian acquisition before?
- Is the acquisition to be structured as a share purchase or an asset purchase?
- Is it critical to structure the purchase arrangement and/or ongoing investment as a tax flow-through structure for U.S. tax purposes?
- Is the U.S. lender/investor an LLC?
- Is it important to ensure that there is high cross-border paid-up capital in either the target or a holding company?
- Are you familiar with unlimited liability companies (ULCs)?
- Is the financing to consist, in whole or in part, of interest-bearing debt to a related U.S. entity?

For the purposes of this discussion, we will assume that the U.S. lender/investor wants to proceed by way of a share acquisition.

### Typical Structure

The typical structure would involve use of a Canadian acquisition corporation incorporated in the appropriate jurisdiction. In Canada, business corporation statutes exist at both the federal level (the *Canada Business Corporations Act*, or CBCA) and in each province and territory. Any Canadian company can be incorporated under any of these statutes, no matter where it is located. While many of the statutes are similar, there are differences that can be significant, depending on the circumstances.

This table shows some of the most frequent jurisdictions of incorporation, together with some of their characteristic advantages:

|   | Federal | Ontario | Alberta | New Brunswick | Nova Scotia |
|---|---------|---------|---------|---------------|-------------|
| No Canadian resident director requirement |         |         |         | ✓             | ✓           |
| Allows for ULC status*                    |         |         | ✓       |               | ✓           |
| Modern, U.S.-style statute                | ✓       | ✓       | ✓       | ✓             |             |
| Highly flexible statute                   |         |         |         |               | ✓           |

\* Discussed below

No matter which jurisdiction is ultimately chosen, the acquisition vehicle is often funded by a U.S. parent by way of interest-bearing debt to equity on a 2:1 basis in order to comply with the thin-capitalization requirements discussed below.

To ensure a tax-efficient structure going forward, the acquisition corporation (usually a special-purpose acquisition vehicle financed, in whole or in part, with debt) and the Canadian target (containing the income-generating business) are often amalgamated immediately following closing. This is mainly because Canada's *Income Tax Act* does not permit consolidated tax returns. Like a U.S. merger, although with some distinctly Canadian features, an "amalgamation" is a statutory means of combining two or more corporations subsisting in the same jurisdiction into one continuing amalgamated corporation possessing all of the property, assets, rights and liabilities of each of the amalgamating corporations. Amalgamation is generally tax neutral, although it does trigger a tax year end for each amalgamating corporation. It is also very efficient from a commercial perspective since assets and liabilities are not considered to be transferred or assumed.

In a nutshell, this "typical" structure will:

- permit the full deductibility of interest by the amalgamated corporation going forward, subject to Canadian withholding tax of 10% on interest payments,
- allow the U.S. parent to repatriate funds on a tax-free basis to the extent of the principal amount of the debt and the stated (paid-up) capital of the shares, and
- ensure that the capital gain on the ultimate disposition of the shares of such corporation is exempt from Canadian income tax by virtue of the Canada-U.S. Tax Convention, provided such shares do not derive their value primarily from Canadian real property.

### **Tax Flow-Through Structures Using ULCs**

Many U.S. investors prefer to structure the acquisition of a Canadian target corporation using a tax flow-through form. This can often be achieved with the help of an entity called a ULC (for "unlimited liability company"). The ULC is a relic of nineteenth-century English company law that survived unnoticed in the Nova Scotia *Companies Act* until its value in cross-border acquisition contexts

was recognized. The province of Alberta recently amended its corporate law statute to permit the incorporation of ULCs. As its name suggests, a ULC is basically a corporation whose shareholders have unlimited liability. In view of this potential shareholder liability, U.S. investors often insert a Delaware limited partnership into the structure described below or take other measures to shield themselves from liability.

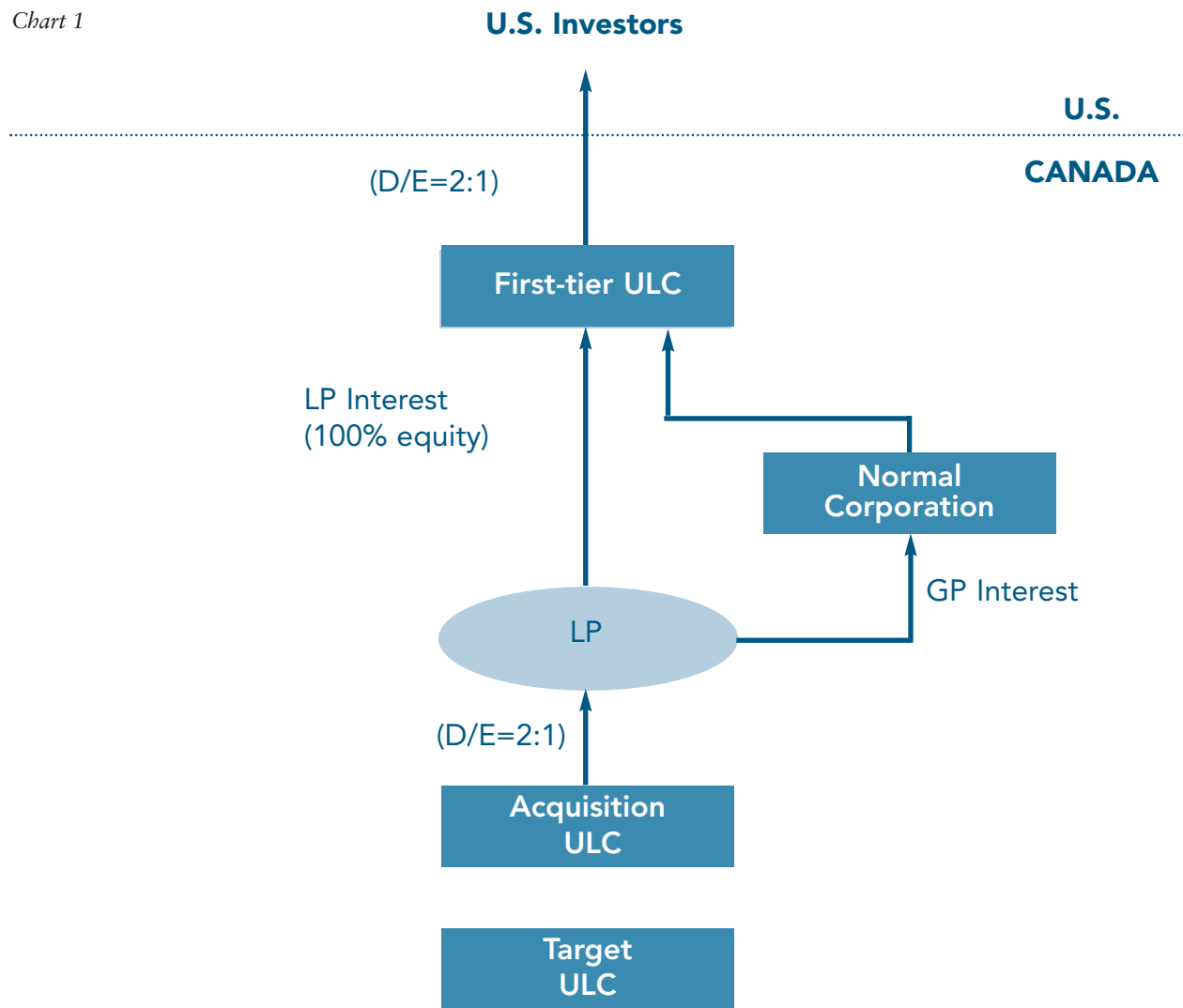
The advantage of structuring a transaction with a ULC derives from the fact that although it is a corporation for Canadian tax purposes it is treated as a flow-through entity for U.S. tax purposes (depending on whether it has one or several shareholders, the U.S. tax authorities treat a ULC as either a disregarded entity or a partnership). The tax result for the U.S. investor will often be advantageous in a number of respects.

Two basic pre-closing steps or series of steps are required to implement a share acquisition using a ULC. First, the U.S. investors must incorporate a ULC ("First-tier ULC"); fund it on a 2:1 debt to equity basis; cause the First-tier ULC to form a normal corporation (i.e. one with limited liability) as a wholly-owned subsidiary to act as a general partner; the First-tier ULC and the normal corporation form a limited partnership ("LP"); the First-tier ULC invests all of its funds in equity of the LP and the LP borrows the debt portion of the acquisition price from a third party lender ("bank debt"); the LP then incorporates a temporary acquisition ULC, on-lends the bank debt and invests in subordinated debt and equity of the acquisition ULC on a 2:1 basis. This structure is represented in Chart 1 (see below).

Having established this structure, it is then necessary, as a second step, to convince the selling shareholders to "export continue" the target corporation, as a ULC, prior to closing. Achieving agreement on this point can be difficult. The author recently acted for U.S. buyers who effected such an arrangement through a consent and indemnity agreement under which:

- the sellers gave the necessary consent and cooperation;

Chart 1



- the buyer would draft (but pre-clear with the sellers) all documents; and pay all costs;
- the buyer would indemnify the sellers;
- the buyer would re-export the ULC if the transaction did not occur; and
- the continuance would be as close to closing as possible.

It was critical in this case that the ULC be formed under Alberta law, since that province would permit continuance directly into an ULC on the actual day of closing (Nova Scotia requires the continuance as a normal limited company followed by a court-approved

amalgamation with a special purpose Nova Scotia ULC formed specifically for such purpose – this can take weeks). In this case, that single advantage clearly overcame the drawbacks of the Alberta legislation: namely that it provides for joint and several liability of the shareholders of the ULC on an ongoing basis and requires 25% resident Canadian directors. In contrast, Nova Scotia’s ULC legislation has no resident director requirement and provides that shareholder (member) liability occurs only when the ULC is wound up and there are insufficient assets to satisfy all creditors. It should be also noted this required the representations and warranties in the purchase and sale agreement to reflect the change in status of the targets at closing. It also required a re-thinking of the opinions delivered at closing, as well as to lenders at closing.

Continuance is a tax-neutral event for Canadian tax purposes and is relatively straightforward from a corporate perspective and normally has no commercial implications.

The acquisition ULC then acquires the target ULC and amalgamates with it, usually by way of short-form vertical amalgamation leaving the amalgamated corporation (“Amalco”) with the same capital structure as the acquisition ULC.

For Canadian tax purposes the Amalco can deduct the interest on the subordinated debt and on the on-lent bank debt in computing its income. However, when the First-tier ULC pays interest to the U.S. investor/lender a Canadian withholding tax of 10% must be remitted. The LP will have interest income on the on-lent bank debt. The LP will also have interest income in respect of the subordinated debt owed by the Amalco, which interest, for Canadian tax purposes, will be allocated to the ULC limited partner (offset by interest expense on debt owed to the U.S. investor/lender).

For U.S. tax purposes, the Amalco is disregarded so that the LP (a foreign corporation for US tax purposes) will be considered to have acquired assets at fair market value, creating a high tax base for U.S. tax purposes. In addition, the First-tier ULC is also disregarded, as is the subordinated debt owed by the First-tier ULC and the interest on such loan will not be interest for U.S. income tax purposes but will be regarded as a distribution from the LP (and taxable in the U.S. only to the extent of the earnings of the LP).

As with the previous structure, U.S. investors and lenders can (1) repatriate funds to the U.S. on a tax free basis through prepayment of the principal of the cross-border debt and return of the paid-up capital of their shares in the First-tier ULC, and (2) generally sell their shares and not be subject to Canadian income tax on the realized capital gain, provided the First-tier ULC’s shares do not derive their value primarily from Canadian real estate. LLCs do not enjoy these advantages under the Canada-U.S. Tax Convention.

### **Structuring Acquisitions by U.S. LLCs**

Many U.S. investors are structured as limited liability companies (“LLCs”) and, as such, are flow-through vehicles that do not pay income taxes in the U.S. In a cross-border context, this raises taxation issues because the Canada Revenue Agency does not consider LLCs to be eligible for exemption under the Canada-U.S. Tax Convention from income taxes on realized capital gains when shares in a Canadian corporation are sold (assuming that the value of shares is not attributable primarily to real property in Canada). In addition, withholding taxes on dividends and interest must be paid at the higher rate prescribed in the *Income Tax Act* (25%) rather than the lower rates prescribed in the Convention (10% on interest and 5% on dividends).

To deal with such issues, a number of investments in Canada by U.S. LLCs have been structured through a third jurisdiction, such as Barbados or Luxembourg, which have favourable tax treaties with both Canada and the U.S. and favourable domestic income tax regimes. The Luxembourg-Canada Tax Treaty has the added advantage of having lower withholding rates than the Canada-Barbados Tax Treaty (dividends 5% vs. 15%; interest 10% vs. 15%).

### **Exchangeable Share Structures**

Exchangeable share structures are often used in cross-border share exchange M&A transactions where there are Canadian resident shareholders. The primary purpose of this structure is to allow the Canadian shareholders to defer the capital gains tax that is normally payable when a non-Canadian company acquires a Canadian company by means of a share-for-share exchange. Canadian tax laws do not currently allow shareholders to “roll over” the cost base in the case of such an acquisition using stock of a non-Canadian company.

An exchangeable share structure is designed to achieve, as nearly as possible, the same result as a pure share exchange. Exchangeable shares are designed to be the functional and economic equivalent, in all material respects, to common stock of the foreign acquiror. The holders of the shares have

a right to exchange them for the shares of acquiror common stock on a share-for-share basis, with a dividend adjustment where necessary. The agreement will typically require a mandatory exchange after a negotiated “sunset” period (generally 5-10 years) or if the number of exchangeable shares outstanding falls below a specified threshold. The value of the shares is kept level with the acquiror’s common stock by means of anti-dilution provisions.

The structure has a number of additional benefits. For example, the acquiror is able to issue common stock equivalents as the merger consideration, avoiding cash and financing requirements and increasing its capital base. It is also able to issue shares into Canada without complying with Canadian take-over bid rules and without becoming a “reporting issuer” in Canada. For its part, the target in an exchangeable share deal benefits insofar as it is not subject to separate reporting requirements under the applicable securities rules.

Exchangeable share transactions are typically implemented by means of a court-approved plan of arrangement requiring supermajority approval of the target’s shareholders (66 2/3% or 75%, depending on the jurisdiction of incorporation). Where a target is private or closely held, it is often possible to achieve the same result without a plan of arrangement. The acquiror and target will usually apply to the relevant Canadian securities authorities for a variety of exemption and relieving orders, which are usually readily granted.

## Specific Tax Issues

### Withholding Taxes

Generally, interest and dividends paid by a corporation resident in Canada to a non-resident lender will be subject to non-resident withholding tax at the rate of 25% (reduced to 10% for interest payments and 5% for dividends – in the latter case if the U.S. investor is a company owning 10% or more of the voting stock (otherwise 15% withholding tax).

### “5-25” Exemption

In most cases, however, interest payments will qualify for exemption from Canadian non-resident withholding tax under the so-called “5-25” rule. The rule applies where:

- the issuer corporation and the non-resident investor deal at arm’s length.
- the issuer is not obligated under the terms of the debt to pay more than 25% of the principal amount of the debt within 5 years from the date of advance except, generally, upon an event of default or upon the exercise by the debt holder of a right to convert or exchange the obligation for a prescribed security (usually common shares).

### Thin Capitalization Rules

The *Income Tax Act* contains so-called “thin-capitalization” rules which disallow the deductibility to a Canadian corporation on cross-border, interest-bearing debt to the extent that such debt issued to “specified non-residents” exceeds twice its tax equity (generally retained earnings, share capital and contributed surplus attributable to specified non-residents). This rule would apply, for example, on a direct loan by a U.S. parent to its Canadian subsidiary and on the cross-border piece of a loan by a U.S. lender to a U.S. parent company which then on-lends to its Canadian subsidiary.

## Security Regimes

### Personal Property Security

All provinces and territories in Canada (except Quebec) have *Personal Property Security Act* (“PPSA”) legislation modelled after the UCC Article 9, with similar concepts, such as “security interests,” “collateral,” “attachment,” “perfection,” “financing statements,” and detailed rules on priority and realization. In addition, the electronic registration systems are centralized and province-wide. There are differences in the PPSA legislation among the provinces (and between the various PPSAs and Article 9), but generally a U.S. form of security agreement with appropriate modifications (for

example, deletion or modification of non-conforming definitions; the insertion of language permitting the appointment of a “receiver”/“receiver-manager” as a remedy and choice of laws/venue) will be satisfactory. Generally, under the various PPSAs the validity and perfection of security interests will be governed either by the place where the debtor is located or by the place where the collateral is located and not by the governing law of the security agreement. U.S. lenders will feel very comfortable with the protection afforded by Canadian PPSA legislation but the devil is in the detail and there are Canadian laws, both federal and provincial, that could have an impact upon realization and priorities.

Ontario and certain other provinces are proposing to implement securities transfer legislation modelled on UCC Article 8. When this occurs, concepts of securities account transfer agreements and securities intermediaries will become a part of Canada’s personal property security regime.

### **Real Property**

There are two major registration systems for real property across Canada (outside Quebec). These are the Registry system in Prince Edward Island, Newfoundland & Labrador, and parts of Ontario and Manitoba, and the Land Titles or Torrens system in Alberta, British Columbia, Saskatchewan, New Brunswick, Nova Scotia and in large and growing parts of Ontario and Manitoba. The Registry System is a registration of deeds system which provides for the public registration of instruments affecting land but makes no determination as to status of title. Under the Land Titles system, title is effectively warranted by the Crown, subject to certain exceptions. All of these regimes provide security in the form of mortgages/charges and all jurisdictions have detailed rules for the enforcement of mortgage security, including power of sale and foreclosure. Title insurance has also become increasingly popular, particularly in Ontario, with a lender’s policy offering much the same insurance coverage to a lender secured on real property as that in the U.S.

### **Quebec Security**

The principal form of security in Quebec is the *hypothec*, which may be granted to secure any obligation and may create a charge on movable or immovable property, present or future (“movable property” roughly corresponds to the common law concept of “personal property”). It may be made with delivery (a pledge) or without delivery, enabling the grantor to retain rights to use and enjoy the property. The hypothec may charge specific assets or a “universality” of assets. Although the *Civil Code of Quebec* (CCQ) does not provide a definition of universality, this concept includes all, a portion or a particular category of assets, such as all present and future accounts receivable.

The CCQ has not adopted the functional approach to security of the UCC or the common-law PPSA. Therefore, it is still possible to enter into title retention arrangements in Quebec that effectively constitute security. These devices include instalment sales, sales with right of redemption, sales with a resolatory (rescission) clause, leases, leasing contracts and consignments.

### **Other Canadian Law Considerations**

The following are some other issues that U.S. lenders and investors should be aware of:

#### **Gross-Up Clauses**

As noted above, Canadian withholding taxes will normally be imposed on interest payments made by a Canadian borrower to U.S. lenders. U.S. lenders, as a matter of course, will insert gross-up clauses to ensure that the Canadian borrower “tops up” any interest payment to cover any amount withheld and remitted to the Canadian tax authorities. This gross-up will normally increase the effective cost of borrowing to the Canadian borrower.

#### **Currency Act**

Canada’s *Currency Act* precludes the grant of a judgment in any currency other than Canadian dollars. To deal with this fact, U.S. lenders lending in U.S. dollars will invariably insert a currency exchange

provision to ensure they receive the full amount in Canadian currency of the amount that is the equivalent at the date the judgment is issued of the lending currency (i.e. U.S.\$).

### **Judicial System**

Canada has a very well-developed and sophisticated judicial system, similar in form to that in the U.S. Nevertheless there are differences. Among these are the practice of generally requiring the party that loses a case to pay some portion of the winner's legal costs, the rarity of jury trials in commercial matters and the fact that awards of damages are generally much smaller. Generally, and perhaps because of some of these differences, Canadians tend to be far less litigious than Americans. There are some signs that this is changing, particularly with the rise of class actions and, in some jurisdictions, a loosening of restrictions against contingency fee arrangements.

### **No Equitable Subordination**

The "Deep Rock" equitable subordination doctrine of *Taylor v. Standard Gas Co.* generally does not apply in Canada.

### **Criminal Rate of Interest**

Canada's usury laws (contained in section 347 of the *Criminal Code*) make it a criminal offence to receive interest at an effective annual rate in excess of 60%. Importantly, "interest" is broadly defined for such purposes to include interest, fees, commissions and similar charges and expenses that a borrower pays on credit advanced. This could create an issue where warrants, "free" shares or other "equity kickers" form part of the loan transaction. This section has arisen almost exclusively in civil, not criminal, cases as a defence to repayment – borrowers arguing illegality of the loan itself.

### **Interest Act Restrictions**

Canada's *Interest Act* requires that every contract or agreement involving the payment of interest, other than a mortgage, must expressly state an *annual* interest rate. For example, where the repayment period is less than a year (e.g. 360 days) an express statement of the annual equivalent rate of interest is required (otherwise, a 5% annual rate is imposed).

In addition, where loans are secured by a mortgage on real property, a higher rate of interest cannot be recovered on amounts in arrears.

### **Demand Debt**

Before enforcing security, a lender must demand the debtor repay the loan and give the debtor reasonable time to do so, even if the debtor waived these requirements in the loan and security documents. In addition, the lender (or any receiver or other agent) must act in good faith and in a commercially reasonable manner when selling or otherwise disposing of the secured assets.

### **Enforcement of Foreign Judgments**

Under most conditions, Canadian courts will enforce a judgment of a U.S. court of competent jurisdiction without reopening the case on the merits – assuming, among other things, that the court had jurisdiction over the defendant. Canadian courts will be satisfied that the court had jurisdiction if the defendant appeared and defended on the merits, resided in the jurisdiction, had previously agreed to submit to the jurisdiction (e.g. pursuant to either an exclusive or non-exclusive jurisdiction clause) or if there was a real and substantial connection between the defendant and the jurisdiction in relation to the matter which is the subject of the litigation. In addition, the judgment must be for a certain sum of money (e.g. not a specific performance order or an injunction). Certain defences can be raised, for example that the court proceedings were not conducted fairly (i.e. in accordance with principles of natural justice), that enforcement is against public policy or public order (rarely applicable to U.S. judgments), or that the judgment is a foreign tax or penal judgment. Another possible defence is fraud.

### **Guarantees**

Most Canadian corporate statutes contain no restrictions on the grant of guarantees or other financial assistance to related parties, other than general fiduciary obligations imposed on the directors of the granting corporation to act in the best interests of the corporation. A Canadian form

of guarantee generally looks very similar to its U.S. equivalent (containing waivers of equitable defences, waiver of subrogation rights etc.) with the addition of the usual cross-border provisions, including currency conversion and interest, as well as gross-up provisions to deal with any withholding taxes on payments made under, or pursuant to, the guarantee.

### ***Pledge of Securities***

Once again, a Canadian form of stock pledge agreement would look very similar to a comparable U.S. form of agreement. However, as noted above, the shareholders of an Alberta ULC (or “members” of a Nova Scotia ULC) have potentially unlimited liability to creditors of the ULC. For this reason, some U.S. lenders are reluctant to take a pledge of

stock in a ULC on the theory that they may have a “beneficial” interest in the pledged stock, particularly if they have comprehensive rights of management and control with respect to the ULC under the pledge agreement. Normally, by carefully drafting the pledge agreement, this fear can be assuaged; in particular, by limiting the “ownership-type” rights of the lender/pledgee prior to demand and realization.

### **Conclusion**

U.S. investors and lenders will feel quite comfortable with the legal regime in Canada for both structuring and financing potential acquisitions. However, the devil is in the detail, and there are enough differences and pitfalls to warrant careful planning and implementation. It’s all about the money. ■