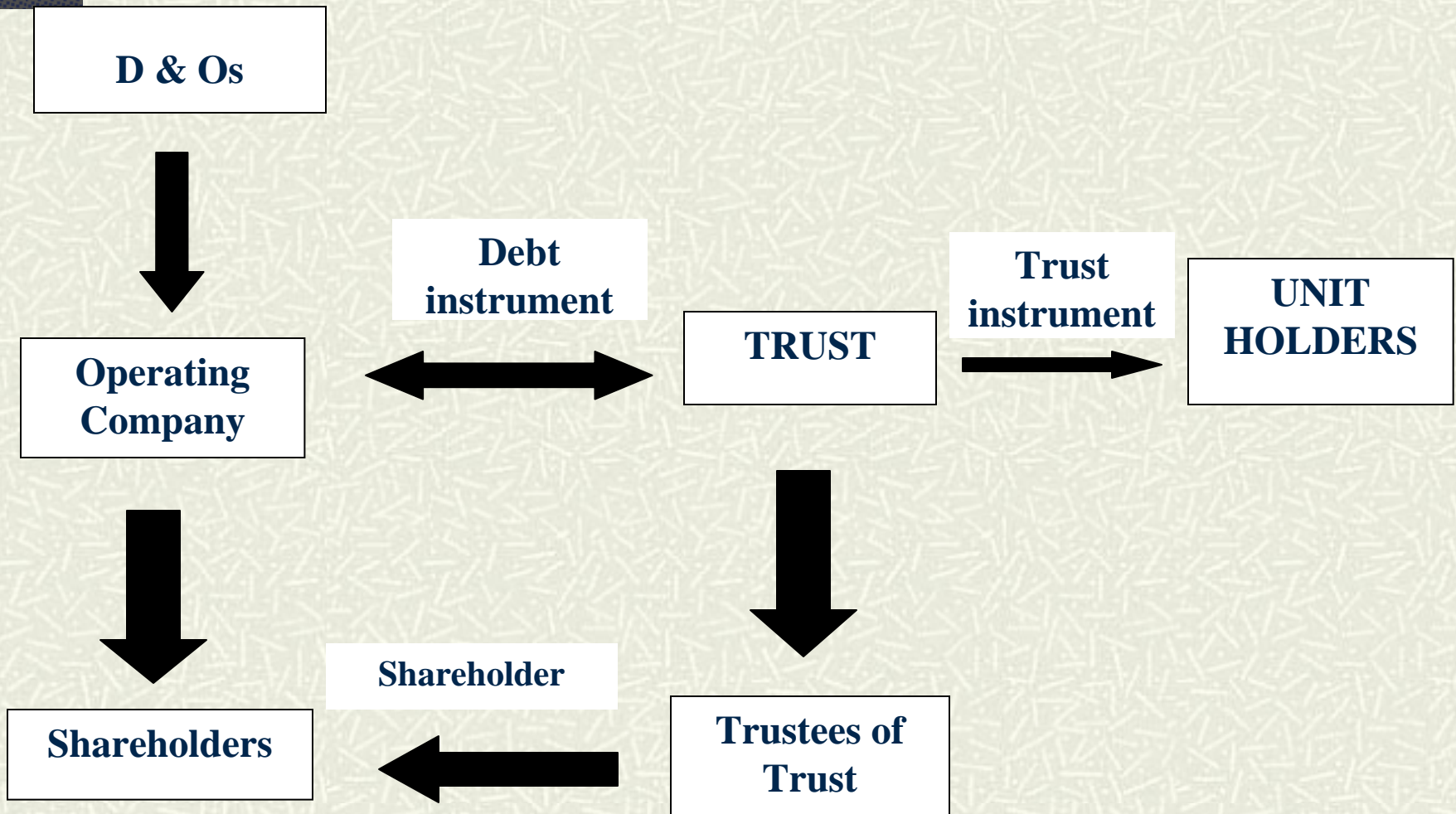




**DOLDEN WALLACE FOLICK** LLP

*Insurance Lawyers*

# SIMPLE INCOME TRUST STRUCTURE

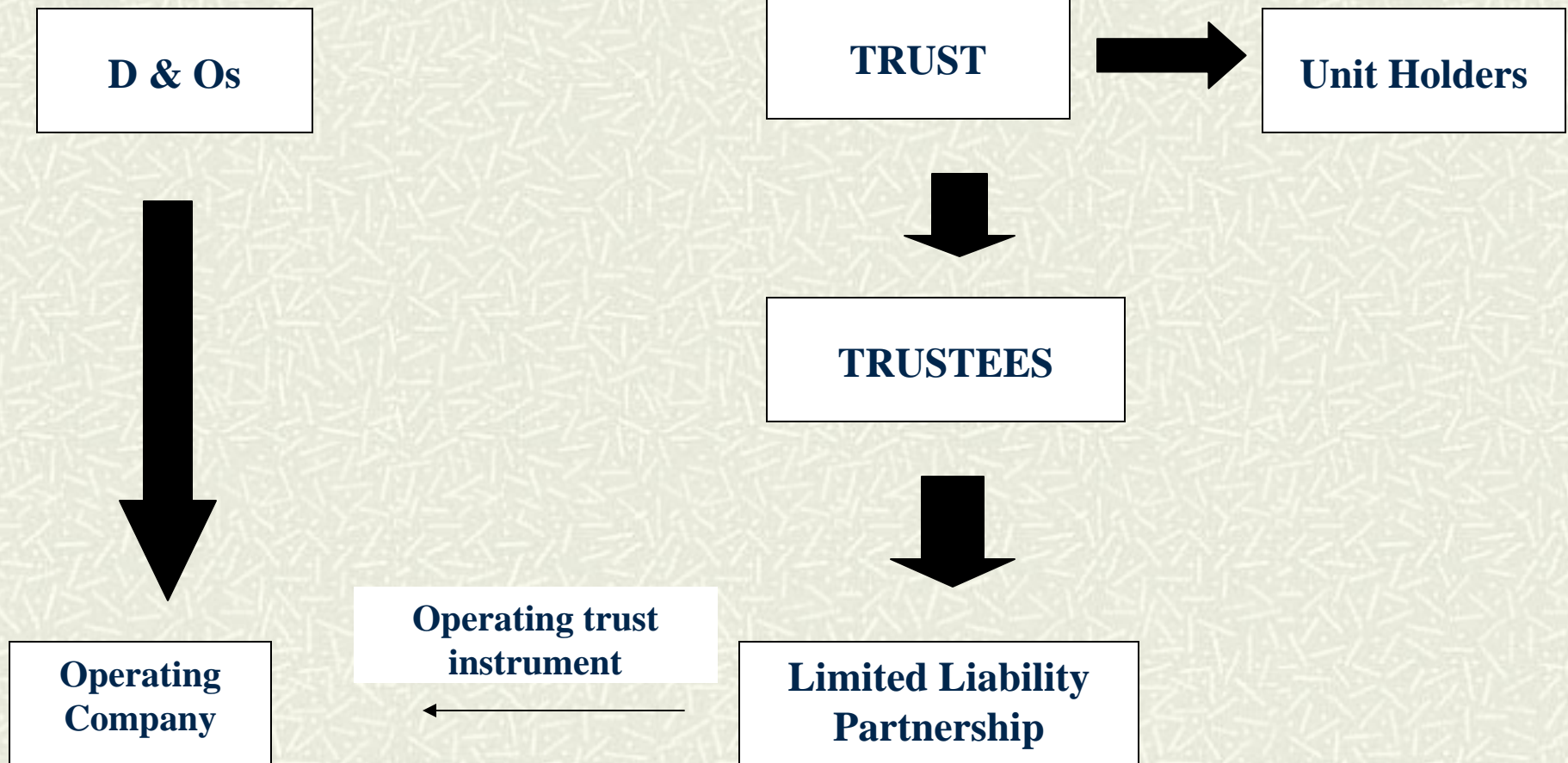


## **The Problem in Income Trusts**

**Unit holders are either one or two steps removed from operating company which makes corporate governance difficult to enforce.**

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# COMPLEX INCOME TRUST STRUCTURE



## What governs an income trust?

- trust indenture - regulates relationship between trustees and unitholders
  - debt indenture - regulates relationship between trust and operating company
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## Legal Regime

- Income Fund
    - “Judge Made” trust law
    - Statutory law of province or territory under which trust is formed
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## Legal Regime

- Tax Law
    - Federal Income Tax Act
  - Bankruptcy Law
    - Proposed amendments (Bill C-55) to the federal Bankruptcy & Insolvency Act and CCAA – to extend to Income Trust
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## Do unitholders have personal liability for actions of trust?

- Potential problem inherent to trust law - unitholders could be liable for trust obligations of trustees
  - response: legislation in Ontario, Alberta, B.C. and Manitoba - enactment of Trust Beneficiaries Act in Ontario in 2004
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## Governance Problems: do unitholders have the protection of shareholders?

- the trustees will typically sit as directors of the operating company
  - the trust is the only shareholder of the operating company
  - result: the unitholders are "one step" removed from control of the operating company
  - why would trustees who serve as directors ever sue themselves for an error?
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## **Governance Problems: do unitholders have the protection of shareholders?**

- since the Trustees are the shareholders of the operating company they can block legal action
  - why do income trusts need a D & O product? Because securities laws apply equally to income trusts and the governance model increases the likelihood of a securities claim
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What are the consequences of being "one step" or "two steps" removed from the ability to govern the operating company?

- unitholders cannot avail of "appraisal remedy" - right to bought out if either the operating company substantially changes its business, or, 90% of shares in operating company are sold
  - unitholders are not shareholders of operating company so cannot use "oppression remedy" under company legislation
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What are the consequences of being "one step" or "two steps" removed from the ability to govern the operating company?

- inability to bring a derivative action - if the directors of operating company commit acts of malfeasance then only the trustees are shareholders in operating company; not the unitholders so no right to correct the wrong
- if operating company enters into management contract for third party to manage company affairs: unitholders cannot directly complain

## Remedies for unitholders if "one step" or "two steps" removed from operating company:

- they have a right to replace trustees of the trust and in turn new trustees take action
  - problem: if the trustees also sit as directors of operating company why will they take action against themselves
  - problem: in some cases the trust instrument will say the trustees only have the obligations of directors; not of trustees
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## Are income trusts caught by securities laws?

- income trust units are "securities" under provincial securities laws
  - Ontario Securities Commission and TSX impose special reporting obligations on income trusts
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## Are income trusts caught by securities laws?

the obligation of disclosure is wider than for companies – special requirements for disclosing:

- "distributable cash"
  - "material debt" ranking ahead of unitholders
  - when trust in breach of financial covenants
  - National Policy 41-201 requires income trust financial results to include the operating company results
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## **Securities Regulations for Income Trusts**

- **Province or territory in which Income Fund is a reporting issuer:**
    - **Prospectus liability and civil liability for continuous disclosure**
    - **National Instrument 58-201 – Corporate Governance Guidelines**
    - **Staff Notice 41-304 – Prospectus Disclosure of Distributable Cash**
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## Why income trusts more likely to run afoul of securities laws?

- operating company typically a private company – not a public company
  - result: no requirement to make disclosure of "material change" in operating company affairs
  - so, operating company can experience adverse results that can impact on cashflow without prior requirement to disclosure "material changes"
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## Why income trusts more likely to run afoul of securities laws?

- further problem: if trustees sit on operating company board they have a conflict and less likely to disclose "materially adverse" developments
  - trust instrument may reduce their fiduciary duties by reducing it down to corporate director duties
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## Practical result of non-disclosure under securities law

- unitholders are not shareholders in operating company
  - unitholders do not vote for the directors in the operating company
  - unitholders cannot seek redress for legal wrongs in operating company so resort to Securities Act remedies
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## **Why income trusts can run afoul of securities laws:**

- **the relationship between operating company and trust is repayment of debt**
  - **the operating company can enter into third party debt**
  - **the trust debt is subordinate to third party debt**
  - **the trustees, as directors, can enter into too much debt**
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## Why income trusts can run afoul of securities laws:

- practical result: operating company has no funds left over to pay trust
  - unitholders not shareholders so they cannot control amount of third party debt
  - distributions "dry up" as the operating company becomes overwhelmed with debt
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## Why an insurance product is needed for the income trust: likelihood of claim

- public views units like debt but in fact it is more like an equity investment
  - unitholders expect to receive consistent distributions – yet subject to risks in getting dividends
  - whenever distributions are impacted negatively unitholders react quickly and sue
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## Indemnification for Trustees of an Income Trust

- at common law trustee expected to act without compensation
  - if get compensated as a trustee subject to judicial review
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## Indemnification for Trustees of an Income Trust

- Trustee Acts in various provinces requires the trustees to obtain advice in Court before they undertake the defence of an action
  - if you fail to obtain advance judicial approval trustees seriously at risk no right to be reimbursed for defence costs or settlement
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## Why is reimbursement for defence costs and settlement so onerous for trustees of an income trust?

- Section 35 of *Trustee Act* in Ontario - Court expects:
  - (a) prior directions from the Court before you defend yourself
  - (b) proof you acted honestly and reasonably
  - (c) Judge concludes "ought to be excused" from consequences of conduct

## Why is reimbursement for defence costs and settlement so onerous for trustees of an income trust?

- **result:** getting reimbursed for defence costs and the impact of a judgment is very onerous
  - **needed:** a form of coverage that makes defence cost advancement mandatory if no indemnification by Trust
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