NAVIGATING THE QUAGMIRE OF OIL AND GAS TRANSACTIONS WITH INCOME TRUSTS

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This article examines the current trend towards income trust conversion in the oil and gas industry and the various business and legal implications which arise as a result. Documented is the history of the development of the income trust, various methods in which income trusts are managed, structures in which they exist, methods of conversion, and tax treatment. The various implications of income trusts to the oil and gas lawyer are then discussed, with a focus on asset transactions and multi-party deals, as well as the concerns arising for counterparties to a transaction with a trust entity. Finally, evolving issues affecting income trusts are addressed.

Cet article examine la tendance actuelle vers la conversion de fiducies de revenu dans le secteur pétrolier et gazier ainsi que les diverses implications commerciales et juridiques qui en découlent. L'historique de l'évolution de la fiducie de revenu, leurs diverses méthodes de gestion, structures, méthodes de conversion et traitements fiscaux y sont discutées. Les diverses implications des fiducies de revenu pour les avocats de ce secteur y sont ensuite traitées, avec une attention spéciale aux opérations sur les biens et les marchés multipartites ainsi que les préoccupations pour les contreparties à une transaction avec une fiducie. Enfin, on y aborde les questions évolutives concernant les fiducies de revenu.

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I. INTRODUCTION

Although income trusts have almost a 20-year history, their growing popularity in recent years as an investment vehicle in all sectors has given rise to greater interest in the structure of, and issues relating to, trusts as investment vehicles. This article focuses on certain specific issues relating to income trusts in the energy industry. It describes the context in which energy trusts do business with reference where possible to existing energy trusts, commonly used structures, methods of conversion, and governance arrangements. In that context, unique issues which arise when transacting with an energy trust are considered. In the final section, a number of current issues facing trusts are described.

As of July 2004, there were over 150 income trusts trading on Canadian stock exchanges, with an aggregate market capitalization of approximately $90 billion.[1] Thirty percent of initial public offering (IPO) activity in 2004 was attributable to income trusts, with two of the top five IPOs of the year being income trusts. As of 31 December 2004, there were 175 income trusts listed on the TSX with a market capitalization of over $118 billion and representing 8 percent of total market capitalization on the TSX.[2] This increase in the sector has developed from a number of conversions of oil and gas companies to trusts.

A. BACKGROUND

Several Real Estate Investment Trusts (REITs) and oil and gas royalty trusts have been in existence since the mid-1980s.[3] Trusts as business and investment vehicles attracted more interest starting in the mid-1990s. Originally, trusts were used for any business in the mature stage of its cycle, characterized by steady cash flows and little need for capital expenditure.[4] More recently, trusts have been used for a variety of situations and do not necessarily need steady cash flows. Several trusts have undertaken significant capital expansions.

The first energy trusts, including what is now the Enerplus Resources Fund, were created in the mid to late 1980s, and since that time the energy trust sector has continued to grow. From 1995 to 1998 there were 16 IPOs of income trusts in the oil and gas industry.[5] Recent numbers list 32 energy trusts as active issuers and more are expected.[6] Trusts now account for nearly a third of the activity in the Canadian oil and gas sector. Because trusts are well

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1. Alberta, Alberta Revenue, *Income Trusts: Governance and Legal Status*, Discussion Paper (Alberta Revenue, 2004), online: Alberta Finance <www.finance.gov.ab.ca/publications/2004_0728_income_trusts_discussion_paper.pdf> at 4 [*Income Trusts*].
2. Standard & Poor's, News Release, "S&P to Add Income Trusts to the S&P/TSX Composite Index" (26 January 2005), online: Standard & Poor's <www2.standardandpoors.com/spf/pdf/index/012605_tsx.pdf> [S&P].
3. *Income Trusts*, *supra* note 1 at 4.
4. *Ibid.*
5. Paul Halpern, "Is the Trust in Trusts Misplaced? A Study of Business Income Trusts and Their Role in Canadian Capital Markets" (2004), online: Rotman School of Management <www.rotman.utoronto.ca/cmi/IncomeTrust.pdf> at 7.
6. *Ibid.* at 45.

suited to a mature business with stable cash streams, they are an ideal vehicle for exploiting the maturing reserves of the Western Canadian Sedimentary Basin.[7] Energy trusts now appear to have integrated themselves fully into the oil and gas industry, creating in the process a symbiotic relationship with junior oil and gas companies. Since trusts must continuously acquire properties to make up for declining production, juniors make an attractive target. In addition, many juniors choose to convert to trusts, sometimes spinning out new juniors in the process.[8]

For the past four years, approximately 20 percent of respondents to Deloitte & Touche's Oil & Gas Industry Outlook Survey had considered converting into an energy trust.[9] In 2003, slightly less than 20 percent of respondents indicated that they were already an energy trust, and by 2004 this figure had increased to nearly 40 percent. Commentary to the survey results indicates that successful conversion to a trust is determined in part by the quality of the underlying reserves and in part by the demand by investors for trust investments. This demand had increased throughout the first part of 2004 and was expected to continue due to the low interest rate environment. Eighty-two percent of respondents indicated that they expected to see consolidations or mergers of energy trusts in 2004.

B. SECTOR MATURITY

Standard & Poor's (S&P) announced by Press Release dated 26 January 2005 that it would be including income trusts in the S&P/TSX Composite Index.[10] Income trusts are now a significant component of retail and institutional investing activity and are the fastest growing segment of the Canadian equity marketplace. Although S&P will continue to provide a parallel index that does not include income trusts, this move has been described as a "com[ing] of age" for the trust sector.[11] It is anticipated that income trusts will represent approximately 8 percent of the total Index and will increase representation on the Index of the real estate and oil and gas sectors, which has been under-represented in recent years because of the number of issuers in those sectors who have made the move to a trust structure.[12]

Trusts themselves are evolving. Instead of paying out all their cash flow, a number of trusts are using a portion for exploration and capital. A proliferation of newspaper articles and at least one book[13] aimed at ordinary retail investors also show that income trusts have reached the public consciousness as a standard type of investment.

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7 Paul Haavardsrud, "Lure of cash driving trust revolution" *Calgary Herald* (12 February 2005) D1 (ProQuest).

8 Paul Haavardsrud, "Junior oil and gas sector is a licence to print money" *Calgary Herald* (11 February 2005) E4 (ProQuest).

9 "2004 Canadian Oil & Gas Industry Outlook: Survey Results," online: Deloitte & Touche <www.deloitte.com/dtt/cda/doc/content/ca_Energy_Oil%26GasSurvey2004.pdf> at 8-9 [Outlook].

10 S&P, *supra* note 2.

11 Madhavi Acharya & Tom Yew, "Trusts may get boost in joining index; greater demand seen as new units join TSX benchmark Standard & Poor's seeking comment, input on details" *Toronto Star* (27 January 2005) D1 (ProQuest).

12 Madhavi Acharya & Tom Yew, "Trusts in the TSX will bring changes" *Toronto Star* (5 February 2005) D4 (ProQuest).

13 Peter Beck & Simon Romano, *Canadian Income Funds: Your Complete Guide to Income Trusts, Royalty Trusts and Real Estate Investment Trusts* (Mississauga, Ont.: John Wiley & Sons, 2004).

II. STRUCTURE OF THE ENERGY INCOME TRUST

A. WHAT'S IN A NAME? — INCOME TRUST VS. ROYALTY TRUST VS. ENERGY TRUST

Although income trusts are not regulated by statute, it may be useful to examine the definitions of the term put forth by various governmental and regulatory authorities. Perhaps most relevant is the definition adopted in National Policy 41-201, *Income Trusts and Other Indirect Offerings*. This policy has been adopted by many provincial securities regulators (including the Ontario, Alberta, and British Columbia Securities Commissions, effective 3 December 2004), and provides guidance on the sort of disclosure expected from income trusts. It is therefore useful to know that these Securities Commissions define an income trust as

> a trust or other entity (including corporate and non-corporate entities) that issues securities which entitle the holder to net cash flows generated by: (i) an underlying business owned by the trust or other entity, or (ii) the income-producing properties owned by the trust or other entity. This includes business income trusts, real estate investment trusts and royalty trusts.[14]

In its discussion paper on income trusts, the Alberta Government stated the term "income trust"

> refers to a trust relationship in which trust property consists of real property or an interest in an operating entity or active business that produces a reasonably predictable revenue stream.[15]

According to this definition, trust property can consist of the shares, high-yield debt, royalties, and net profits of an operating company, which usually distributes the majority of its net cash flow to the trustee in the form of interest, rent, royalties, or return of capital. This arrangement allows the operating company to reduce its taxable income. The trust, which is considered a taxpayer for income tax purposes (even though it is not otherwise a legal person), can in turn reduce its taxable income by distributing the cash flow to its beneficiaries, known as unitholders. Typically, an income trust can be any trust that derives income, whether by interest, rent, royalty payment, debt repayment, or otherwise, from an underlying business. Recently, we have seen businesses ranging from A&W restaurants to Yellow Pages to oil and gas entities convert their income stream at the corporate level to an income trust that is entitled to receive some form of "income" from its corporate subsidiary.

The terminology in this area can be somewhat fluid. The Securities Commissions and the Alberta Government use the term "income trust" generically, referring to any trust issuing securities and making distributions to its unitholders. The term "royalty trust" is used to describe an entity that is owed a significant (usually 99 percent) royalty or net profit interest (NPI) by an operating entity. In this context the term "income trust" is sometimes used to make a distinction between the royalty trust and a second type of trust structure in which the

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[14] National Policy 41-201, *Income Trusts and Other Indirect Offerings* (2004) 27 O.S.C.B. 9685, online: Ontario Securities Commission <www.osc.gov.on.ca/Regulation/Rulemaking/Current/Part4/pol_2004 1203_41-201_income-trusts-oii.pdf>, s. 1.2 [NP 41-201].

[15] *Income Trusts*, *supra* note 1 at 3.

trust owns all of the outstanding shares, units, or other interest in an operating entity and advances funds to that entity in return for debt and interest. The term "energy trust" does not describe any one specific structure, but instead refers to the use of a trust in the oil and gas industry. The term "energy trust" will be used throughout this article to describe all trust structures operating as oil and gas issuers whether they are structured as royalty trusts, income trusts, or otherwise.

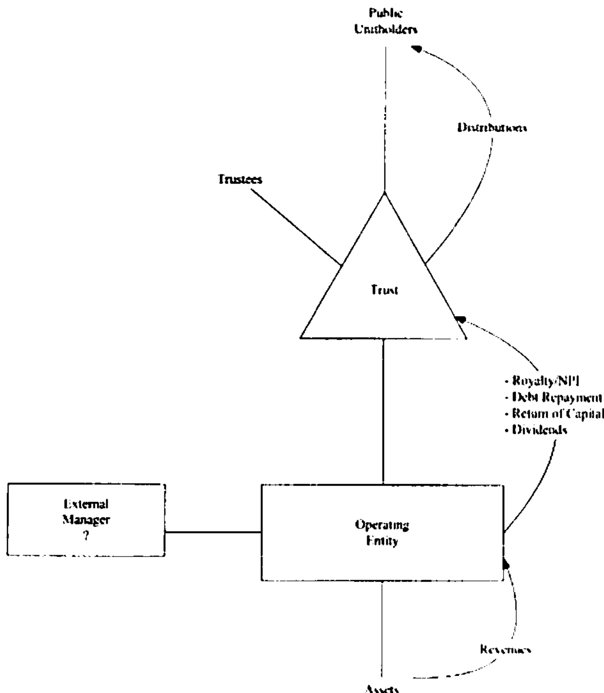
B. STRUCTURE OF A TRUST

1. GENERAL

NP 41-201 gives a short definition of the typical structure of an income trust:

> Typically, an income trust holds a combination of debt and equity or royalty interests in an entity owning or operating a business [the operating entity]. Net cash flows that are generated by the operating entity's business are distributed to the income trust. The income trust then distributes that cash flow to its investors (referred to as unitholders or investors).[16]

Although this definition covers the basics of an income trust's structure in its generic sense, there are several choices for how this may be accomplished. Some of the more common structures are discussed in more detail below; however, at their most basic the trust structure will likely look as follows:



[16] *Supra* note 14, s. 1.4.

2. ROYALTY TRUSTS

The royalty trust structure is elegant in its simplicity. It is typical of many of the earlier entries into the arena of energy trusts. For example, in Canadian Oil Sands Trust, originally created in 1985, the trust owns 100 percent of the capital stock of Canadian Oil Sands Limited, which in turn has granted to the trust a 99-percent net royalty interest. The operations of Canadian Oil Sands Limited, a wholly-owned subsidiary, consist of acquisition, management, and disposition of oil sands interests and various related rights. The royalty granted by Canadian Oil Sands Limited to the trust consists of 99 percent of the revenue generated by Canadian Oil Sands Limited's interests in the Syncrude Joint Venture, net of various charges including operating costs, debt service charges, general and administrative costs, and taxes.

In a royalty trust structure, the amount of money payable by the operating entity to the trust varies with the amount of revenue generated by the operating entity. Because the royalty is payable on a percentage of the operating entity's revenue, in a year in which the operating entity generates $100 of revenue, it pays $99 as a royalty to the trust, but in a year in which it generates $200 of revenue, it pays $198 as a royalty to the trust. The operating entity may then deduct 100 percent of its royalty expenses from its taxable income for that year.

The royalty trust structure is not appropriate in all situations. For instance, a royalty can only be granted on oil and gas property (for example, it would include mineral interests, but not a partnership holding a mineral interest) and not on other aspects of the oil and gas industry that might be generating income for the operating entity. Where a royalty trust structure is considered undesirable or inappropriate, a variety of income trust structures may be used instead.

3. OTHER TRUST STRUCTURES

Trust structures not following the royalty trust model can become significantly more complex. A review of some other structures used in the energy trust industry reveals trusts on top of several subsidiaries and operating companies, trusts on trusts on partnerships, and other even more complex structures.

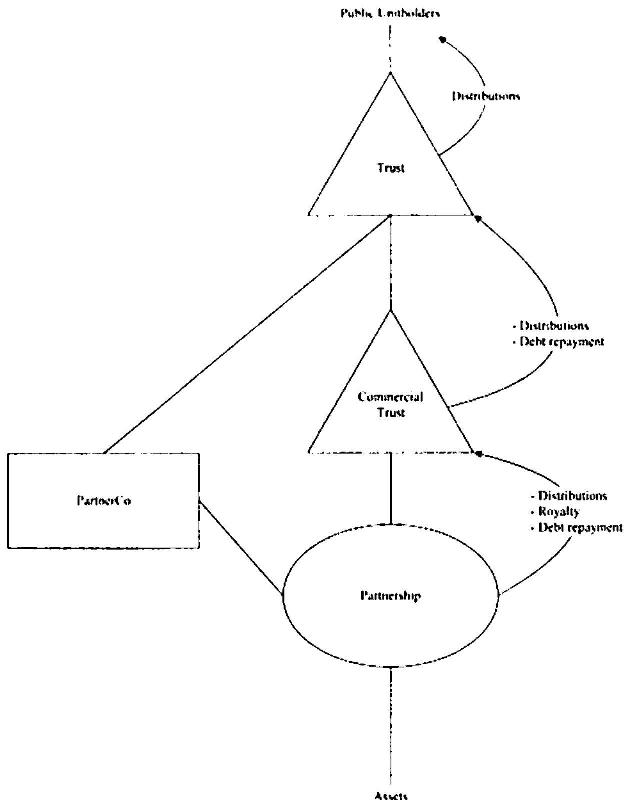
In an example income trust structure, where this term is used to distinguish the structure from a royalty trust, the trust advances $1000 of debt to the operating entity at 10 percent interest per annum. The operating entity thus owes the trust $100 per year, which is deductible as interest expense. Assuming the operating entity generates $100 of revenue in that year, its revenue is balanced out by the interest it owes and it has no taxable income in the year. If the operating entity generates $200 of revenue in a year, not all of this revenue will be balanced out by the interest owing and it will have some taxable income for the year. The interest owing by the operating entity to the trust is generally considered deductible by the Canada Revenue Agency if the interest:

a) accrues on a day to day basis
b) is referable to a principle amount

c) is considered compensation for the use of money.[17]

A more recent trend is to provide for "participating payments" being an amount of interest that fluctuates based on income. In addition to the foregoing, the "participating" interest must reflect prevailing arm's-length commercial interest rates.[18] Despite the fact that an operating entity under an income trust structure may become taxable if the business grows too quickly, it is considered more flexible than a royalty trust structure. An income trust, or more properly its operating entity, may own any kind of assets that produce revenue.

In the energy trust sector, the income trust model is frequently combined with the royalty trust model to produce a structure in which a wholly-owned operating corporation owes both royalty and interest payments to the trust. The Acclaim Energy Trust is a straightforward example of this model.[19] The trust owns 100 percent of the common shares and notes issued by its operating corporation. An even more frequent structure in this industry, however, is the trust on top of a limited partnership through a second commercial trust.



[17] *Income Tax Act*, R.S.C. 1985 (5th Supp.), c. 1, s. 20(1)(c); M.N.R., Interpretation Bulletin IT-533, "Interest Deductibility and Related Issues" (31 October 2003) [IT-533].

[18] IT-533, *ibid.*

[19] For general information concerning Acclaim Energy Trust, see Acclaim Energy Trust, "Annual Information Form" (filed 13 May 2004), online: SEDAR <www.sedar.com> [Acclaim Energy Trust AIF].

This structure represents a third method of putting the revenues of the operating entity in the hands of the trust for distribution to the unitholders. The entity, usually a commercial trust holding a partnership interest in the limited partnership, receives income from the partnership in proportion to the amount of its partnership interest. Those funds may then be distributed by the commercial trust to its unitholder, the trust. No royalty or debt structure is required to transfer funds from the limited partnership to its partners. When Canadian Oil Sands Trust purchased its additional interest in the Syncrude Joint Venture in 2003, Canadian Oil Sands Trust used a commercial trust for tax reasons, to hold its new interests in a limited partnership which in turn held an interest in Syncrude. The limited partnership paid a gross overrriding royalty (GORR) to the trust and then distributed income to the commercial trust, which in turn repaid some debt owing along with a distribution to the trust.[20]

Calpine Natural Gas Trust, the result of an IPO, holds a 99.99 percent limited partnership interest in an operating partnership through a second commercial trust.[21] The trust also wholly owns the managing partner of the operating partnership. The commercial trust is capitalized through the trust's holding of commercial trust units and commercial trust notes. The notes bear interest at 1 percent per annum, payable monthly, subordinate to all senior indebtedness and the commercial trust units yield monthly cash distributions. Distributable cash of the commercial trust therefore consists of partnership income; the distributable cash of the trust to its unitholders consists both of the distributable cash paid by the commercial trust to the trust and amounts paid on the commercial trust notes as interest and principal.

The Enterra Energy Trust was created as a result of a plan of arrangement through which a previously existing corporate reporting issuer reorganized into a trust structure.[22] The trust owns 100 percent of the trust units of a commercial trust, as well as a number of commercial trust notes. The commercial trust owns 100 percent of the shares of an "exchangeco," allowing former shareholders of the corporate reporting issuer to hold shares exchangeable for units of the trust. The commercial trust also owns 100 percent of the shares of the former corporate reporting issuer. That corporation owns a 99.99 percent limited partnership interest in an operating partnership and also 100 percent of the shares of the general partner of the partnership. The cash flow of the trust is provided by payments of interest and principal from the corporation and the commercial trust in respect of notes issued by each to the trust. The notes issued by the corporation to the trust bear interest at a rate of 14 percent per annum payable monthly and are unsecured. The notes issued by the commercial trust to the trust bear interest at a rate that is reset from time to time to approximate the return on shares of the corporation held by the commercial trust and are subordinated to senior debt. These sources of income form the basis of the distributable cash of the trust payable to unitholders.

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20 For general information concerning the Canadian Oil Sands Trust, see Canadian Oil Sands Trust, "Annual Information Form" (filed 24 March 2005), online: SEDAR <www.sedar.com>.

21 For general information concerning Calpine Natural Gas Trust, see Calpine Natural Gas Trust, "Annual Information Form" (filed 28 April 2004), online: SEDAR <www.sedar.com> [Calpine Natural Gas Trust AIF].

22 For general information concerning Enterra Energy Trust, see Enterra Energy Trust, "Annual Information Form" (filed 20 May 2004), online: SEDAR <www.sedar.com>.

Canadian Oil Sands Trust is the result of a merger of two former trusts.[23] In 2004, it owned 100 percent of the common shares of Canadian Oil Sands Limited and 100 percent of the ordinary units of a commercial trust. Canadian Oil Sands Limited paid a net royalty to the trust and a smaller net royalty to the commercial trust. The commercial trust was a 75-percent general partner of an operating partnership, which paid a small gross overriding royalty to the trust. The commercial trust distributed the partnership income net of its expenses to the trust as holder of its ordinary units and Canadian Oil Sands Limited as holder of special units. The distributable income of the trust is comprised of royalty payments from both the commercial trust and the operating company, as well as the partnership income. Additionally, debt service costs are paid by Canadian Oil Sands Limited to the trust.

4. DEBT SERVICE

Some trusts put in place a large debt obligation owing by the operating entity to the trust. Any interest paid on the debt is deductible by the operating entity and is in turn deductible by the trust when those amounts are paid out to unitholders. Careful consideration is needed, however, as the repayment of principal is not deductible and therefore does not allow the operating entity to "shelter" income.

5. DIVIDENDS AND DISTRIBUTIONS

The key feature in any income trust structure is the ability of the trustees to make distributions of the trust's income to its beneficiaries, called "unitholders." There is a strong incentive to do so because income to be distributed to the unitholders is not taxable in the hands of the trust. The trust indenture will usually set out the conditions under which distributions are made. For example, Petrofund Energy Trust, established under a royalty trust structure, assesses a number of factors in determining quarterly distributions, including fluctuations in oil and gas prices, fluctuations in the Canadian/U.S. exchange rate, the size of its current drilling programs, and the current level of debt of the operating entity.[24] NP 41-201 sets out expected disclosure relating to the factors that determine the frequency and amount of distributions.[25] Income trusts have gained popularity in part because of the apparent frequency and stability of cash flow they provide to investors. This aspect of NP 41-201 aims to ensure that investors receive as much information as possible about the factors affecting this cash flow. The special energy trust focuses on stable distributions, be they quarterly or monthly. Unlike conventional corporations whose dividends tend to be annual and small in quantum, a trust typically has "steady income" flowing to its unitholders.

6. OPERATING ENTITIES

Trusts do not exist in isolation, but receive their income from one or more operating entities. In the simplest form, the operating entity is a single corporation wholly owned by the trust and owing the trust either royalty or debt payments or a combination of both.

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[23] *Supra* note 20 at 4.

[24] For general information concerning Petrofund Energy Trust, see Petrofund Energy Trust, "Renewal Annual Information Form" (filed 15 March 2005), online: SEDAR <www.sedar.com>.

[25] *Supra* note 14.

Throughout this article Petrofund Energy Trust has been used as an example of this type of structure. Another slightly more complex example of a trust on top of corporations is the Enerplus Resources Fund, which owns three successive nesting subsidiary corporations. Dividends of a corporation are taxable, so royalty or interest payments must be created in order to move the operating corporation's revenue up to the trust in a tax efficient manner.

The alternative to an operating corporation is a partnership. Partnerships are flow-through entities for tax purposes, meaning that revenue generated by the partnership is taxed in the hands of the partners. Up until this year, interests in partnerships have been considered foreign property for tax purposes, so a second "commercial trust" was required to be interposed between the trust and the partnership. The Calpine Natural Gas Trust, described earlier, is an example of this type of structure. The Canadian Oil Sands Trust demonstrates a variation on this model, as its interest in the operating partnership, through its commercial trust, is as a general partner. Interestingly, the Canadian Oil Sands Trust received income from two different operating entities, the other being a wholly-owned operating corporation.

Under the new 2005 budget, partnerships are no longer considered foreign property, meaning that the commercial trust could in most cases be dispensed with and the trust could itself become the 99 percent limited partner of the operating partnership. No examples of this simplified operating partnership structure have been seen to date. In general, there are no inherent advantages or disadvantages to either an operating corporation or an operating partnership model. While previously there have been issues regarding liability that dictated the use of a corporation, the changes to the *Trustee Act*[26] in 2004 have removed this concern. Instead, the structure of a trust is usually determined with an eye to minimizing the tax consequences to the sponsors or vendors of the entity converting to a trust.

7. THE TRUSTEE(S) — INDIVIDUAL VS. CORPORATE

In 1998, Robert Flannigan recommended that trustees incorporate to arrange for limited liability and to shift the fiduciary obligation previously imposed on individual trustees to the corporate trustee.[27] All the energy trusts surveyed employed a corporate trustee, with Computershare Trust Company of Canada, Valiant Trust Company, and Olympia Trust Company being the favourites. By a services agreement or administration agreement, power to administer the business and affairs of the trust are delegated by the trustee to an entity affiliated with the trust and usually wholly owned by it.

It seems that in some sectors, as governance becomes of increasing importance to investors, the appointment of corporate trustees has fallen out of favour. For example, the trust deed of the Newalta Income Fund, a provider of services to the oil and gas industry, provides that there shall be not less than three and not more than ten trustees.[28] These trustees are given powers and responsibilities similar to those legislated for directors under the

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26 R.S.A. 2000, c. T-8, as am.

27 Robert Flannigan, "Business Applications of the Express Trust" (1998) 36 Alta. L. Rev. 630 at 636.

28 Newalta Income Fund, "Renewal Annual Information Form" (filed 13 May 2004), online: SEDAR <www.sedar.com> at 23.

Alberta and federal *Business Corporations Acts*.[29] Similarly, the recently created Gienow Windows and Doors Income Fund, an example of an income trust in a sector unrelated to the oil and gas industry, employs five individual trustees.[30] Given that a director of a corporation must be an individual to ensure accountability to the shareholders, the potential personal liability of an individual trustee, especially in light of corporate governance rules, means that very few individuals want to assume this liability.

Eventually governance concerns relating to trusts may be best addressed by considering the powers and responsibilities of the trustee(s). While management of trusts is largely in the hands of corporate trustees who delegate to management companies, as it is in the oil and gas sector, it is more appropriate to discuss governance concerns that arise out of this particular management structure.

8. THE MANAGEMENT COMPANY

All of the energy trusts surveyed employed as manager of the trust an entity either affiliated with or wholly owned by the trust. These management corporations may or may not be entitled to reimbursement for their services. Where management services are provided by an entity other than the issuer, disclosure is generally made respecting the directors and officers of the managing entity as though they were the directors and officers of the issuer. This ensures that unitholders are given adequate information about the persons who are, in effect, managing the entity in which they have invested. Unitholders are also commonly entitled to direct the trustee as to the election of directors of the managing corporation. Essentially, this provides unitholders with the same disclosure and control respecting the management of a trust that they would have by statute were they shareholders of a corporation. Unitholders may not, however, have the same remedies against management as they would by statute in a corporate structure.

In 1990, shortly after the Petrofund Energy Trust commenced operations, its operating entity entered into a management agreement with a related management corporation, pursuant to which the management corporation carried on the management of the trust. Under this agreement a number of management, acquisition, and disposition fees were payable to the management corporation. More recently, in 2003, management of this trust was internalized when the trust's operating corporation acquired all the shares of the management corporation and the fees payable pursuant to the management agreement were eliminated.[31]

In some situations, the sponsor of a trust may be given the ability to control or partially control the trust, either through special voting rights in the trust or the operating entity, or the right to select a certain number of directors of the operating entity. The operating entity of the Calpine Natural Gas Trust is a corporation wholly owned by the trust.[32] That corporation owns a 0.01 percent general partnership interest in a limited partnership, which has as a

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[29] Alberta *Business Corporations Act*, R.S.A. 2000, c. B-9; *Canada Business Corporations Act*, R.S.C. 1985, c. C-44.

[30] Gienow Windows & Doors Income Fund, "Final Long Form Prospectus" (filed 8 October 2004), online: SEDAR <www.sedar.com> at 65.

[31] See *supra* note 24.

[32] *Supra* note 21.

99.99 percent limited partner a commercial trust, which is itself wholly owned by the publicly traded trust. The assets are held by the limited partnership. The operating corporation has also been delegated the authority to manage and administer the trust. Twenty-five percent of the units of the trust are owned by Calpine Corporation. Pursuant to the terms of a governance agreement, so long as Calpine Corporation owns more than 15 percent of the units of the trust, it may elect three out of a minimum seven and maximum 11 directors of the operating corporation. Ownership of between 8 percent and 15 percent of the units entitles Calpine Corporation to elect two directors, and ownership of between 1 percent and 8 percent of the units entitles Calpine Corporation to elect one director. Calpine Corporation wholly owns a services corporation that provides certain administrative and operating services to the operating corporation. These services, for which the services corporation is reimbursed, include assisting the operating corporation in performing its duties and obligations in respect of the trust.

Canadian Oil Sands Trust, as we have seen, consists of a structure in which the trust owns both an operating corporation and a commercial trust owning a general partnership interest in an operating partnership.[33] The operating corporation manages both the trust and the commercial trust's interest in the partnership. This is often referred to as "internal management" and may be seen by investors as a more cost effective structure for managing the trust. This is the approach most trusts now follow. Institutional holders especially disfavour any external management fees.

C. SETTING UP A TRUST

NP 41-201 sets out disclosure requirements for public offerings and reorganizations relating to income trusts. Although the subscribing Securities Commissions indicate that the existing regulatory framework captures the issues relating to income trusts, they have adopted this policy to clarify how that framework relates to income trusts.[34] It is therefore necessary to consult this policy before creating a trust, whether it is to be a new trust or a conversion, to ensure that proper disclosure standards are met.

Income trusts must fulfill certain structural requirements under the *Income Tax Act*[35] in order to receive the tax treatment that makes them so popular. In particular, a trust must be a mutual fund trust pursuant to s. 132 of the *Income Tax Act*. This section requires compliance with the following criteria:

(1) The trust must be a unit trust resident in Canada pursuant to s. 108(2) of the *Income Tax Act*. This is accomplished by making the units of the trust redeemable on demand of the holder.

(2) The trust must restrict its activities to investing of funds in property other than real property or an interest in real property.

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33 *Supra* note 20.
34 *Supra* note 14, s. 1.1.
35 *Supra* note 17, s. 130.

(3) A class of units of the trust must be qualified for distribution to the public.

(4) There must be not fewer than 150 unitholders who hold not less than a prescribed number of units, each block of which has a fair market value of not less than $500.

Keeping these legislative and regulatory requirements in mind, there are two primary methods by which a trust may be set up. It may be the product either of an IPO, in which a privately held entity becomes a publicly held trust, or of a plan of arrangement, in which an existing public entity converts to a trust.

1. FROM SCRATCH — INITIAL PUBLIC OFFERINGS

Approximately half of currently active energy trusts are the result of an IPO. The mechanics of an IPO of a trust are largely similar to the mechanics of a conventional IPO. Owners of a business will decide that they need money to expand and will accomplish this by issuing new shares of the business to the public. The business owners retain their initial interest in the business, but this is diluted by the number of shares offered to the public. In a related type of transaction, known as a secondary offering, owners of a business offer their own shares of the business to the public. The business does not raise new money but the business owners receive money in return for their shares. All IPOs, including those involving trusts, are subject to the disclosure requirements mandated by the Securities Commissions.

When these two types of transactions are effected using a trust model, a new trust issues units to the public. The trust can then acquire the shares of and advance funds to an existing private business. The business owners may either retain their original interest in the business or accept funds in return for their share or a part of their share of the business. Where the initial business owners retain an interest in the business, they may be given special rights in respect of the election of directors of the manager of the trust, as seen in the discussion of the management structure of the Calpine Natural Gas Trust. The particulars of the structure of the operating entity or entities beneath the trust will be largely determined in such a manner as to ensure tax efficiency for the sponsor or selling business owners.

2. TRUST CONVERSIONS

Conversion to a trust may be effected through a "plan of arrangement" under s. 193 of the Alberta *Business Corporations Act*[36] or similar provisions of other provincial and federal business corporations acts. The mechanics vary but usually require the transfer of common shares of the converting corporation to the trust in exchange for trust units and transfer of the common shares by the trust to a subsidiary acquisition corporation in exchange for notes. The converting corporation is then amalgamated with the acquisition corporation to create a new subsidiary operating corporation.

After creating an arrangement agreement, it is necessary to obtain an interim order from the court providing for the calling of a meeting of security holders. The information circular for this meeting requires "prospectus level" disclosure and should include the interim order

[36] *Supra* note 29.

and a detailed description of the arrangement, with the arrangement agreement attached. It should also include a summary of income tax considerations, a fairness opinion, risk factor disclosure, financial statements, and other information respecting both the operating entity and the income fund. The arrangement must be approved by at least 66 2/3 percent of the votes cast by all security holders voting as a single class. Most plans of arrangement also provide security holders with dissent rights.

After the vote, the court must issue a final order approving the arrangement. The court will typically consider whether there has been strict compliance with the statutory requirements for the arrangement, whether the arrangement has been put forward in good faith, and whether the arrangement is fair and reasonable. The final order and articles of arrangement must be filed with the corporate registry and various other securities regulatory approvals may be required. The arrangement will also be conditional on the TSX approving the substitutional listing of the trust units. This process should take between 75 and 90 days.

D. TAX TREATMENT OF AN ENERGY TRUST

The tax treatment of trusts appears to be one of the key factors in their continuing popularity. Although a trust is a "taxable entity" under the *Income Tax Act*,[37] it can reduce its taxable income by making distributions to its unitholders. Under a trust arrangement, this income is taxable only in the hands of the unitholders.[38]

The advantage of a trust structure for tax purposes comes from the fact that a trust may arrange to have no taxable income. Unlike a corporation, which must pay tax on its income before distributing it to shareholders via dividends, a trust may distribute all of its income to the unitholders before paying tax. This increases the amount of income payable to the investor and the benefit of the trust structure increases even further when the investor is itself a tax-exempt entity, such as a pension fund or RRSP.[39]

The operating corporation will not be taxed on any income it pays out as a royalty. In an income trust structure, the operating corporation owes the trust not a royalty, but debt and interest. The operating corporation may deduct this interest in computing its income and may also deduct its resource allowance. Royalties, interest, and dividends must all be included in the trust's computation of its income, but the trust may also make deductions for its resource allowance.[40]

The 2004 federal budget left tax treatment of income trusts unchanged, but limited the ability of tax-exempt entities, such as pension funds and RRSPs, to invest in income trusts. However, these limits were suspended in May of 2004 following lobbying by the Ontario Teachers Pension Plan Board and other pension plans.[41] The 2005 budget removes the ceiling on the allowed amount of investment in foreign property, removing the requirement to

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37 *Supra* note 17, ss. 104-108.

38 *Income Trusts*, *supra* note 1 at 3.

39 Brian R. Carr, "Commodity Financing Alternatives" (2-3 December 2004), online: *in*Conference <http://inconference.insightinfo.com>.

40 *Ibid.*

41 Ray Turchansky, "Alberta posits income-trust liability bill" *Edmonton Journal* (8 May 2004) H5.

interpose a commercial trust between an operating partnership and an issuing trust. This could prompt existing trusts to streamline their structures and encourage the development of new types of income trusts involving partnerships.

Respondents to Deloitte & Touche's 2004 Oil & Gas Industry Outlook Survey were asked about the expected impact of taxing energy trusts in a way similar to companies.[42] Thirty-four percent of respondents expected a positive impact on both their organization and the industry. Thirty-two percent expected a negative effect on their organization, while 44 percent expected a negative impact on the industry. Commentary to the survey question indicates that existing trusts viewed taxation as negative. Further commentary suggests that equal tax treatment would likely "level the playing field" between trusts and corporations and may negatively impact companies planning to increase shareholder value by converting to a trust.

III. KEY VALUE DRIVERS

Given the need for a trust to pay out a certain amount of income as cash to its unitholders, certain key drivers apply to any conversion or sale of assets to a trust or suggest the nature of assets which might be sold by a trust. The following outlines these drivers.

A. MAINTAINING AND IMPROVING DISTRIBUTIONS

A group of assets or business that has either a current income stream or potential for a current income stream is attractive to a trust. Typically, mature oil and gas assets were better suited to the trust sector. Firstly, there was an existing stream of cash flow from wells already in production. More recently, there has been a concentrated effort by the operators of income trusts such as ARC Energy Trust and Enerplus Energy Trust, to use engineering technology and geological knowledge to improve the rate of returns from existing reservoirs. Since the cost of capital for a trust is typically less than that of the larger corporations, many of the assets that have decline rates with lower "total payout loads" that would meet the return on capital of a multinational entity have been sold to trusts. Enerplus, for example, acquired the assets of Devon. Since the overhead at Enerplus was lower than most majors, they were able to go back into resource plays that had otherwise been abandoned or not pursued due to the capital costs and minimal perceived reserves to release those resources.

B. RESERVES AND PRODUCTION

Since the value of a trust is inherently determined by the life of its assets and the ability of those assets to produce income, trusts place a high value on reserve life. As demonstrated in the chart below, the conventional oil and gas trusts have been experiencing steady declines in their reserve life.[43]

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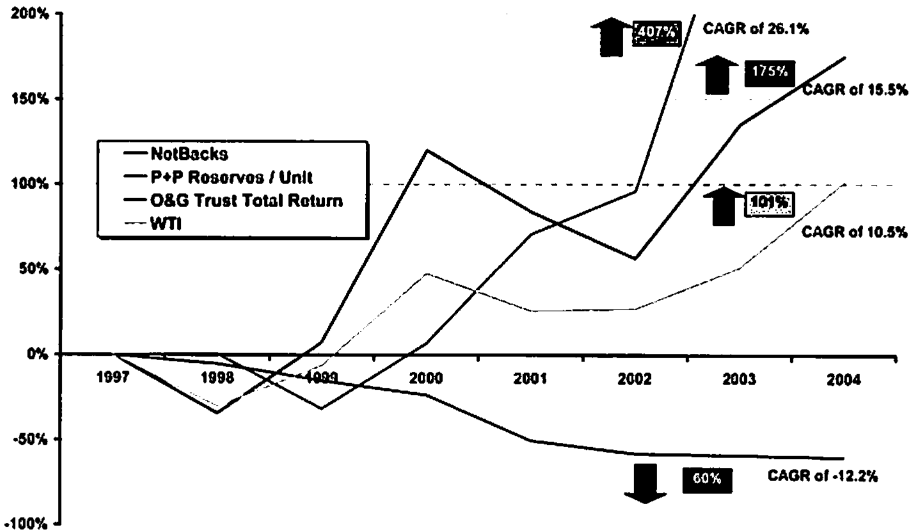
[42] Outlook, *supra* note 9 at 9.

[43] The following chart has been reprinted courtesy of RBC Capital Markets.



As reserve life declines, the trust's ability to produce oil or gas declines and, accordingly, so does that trust's revenue stream. The result is that many of the conventional oil and gas trusts are viewed as being on a treadmill to acquire more producing or producible assets constantly. This can be seen in the proliferation of trusts as the purchaser of a number of the oil and gas assets sold off by the majors. Arguably, the shorter the reserve life, the less value a property has; conversely, the longer the reserve life, the more value. The one particularity with this is that in determining the impact on accretion per unit, an acquisition that has a longer reserve life will actually be less accretive to the unitholder since the accretion is determined over the life of the asset. Hence, the shorter the life, the more instant the accretion. Having said that, the conventional oil and gas trusts would like to "smooth" the reserve life and, therefore, if they could add a long-term reserve asset, such as an oil sands asset, many of them would do so.

Those trusts that have an established base of income or production are willing to look at potential exploration opportunities. Entities such as Enerplus have announced in recent years that they are undertaking exploration. While typically this exploration has focused on drilling wells in areas surrounding existing production and hence are more delineation wells, there has been a move towards actual higher risk exploratory wells in regions without a production history. For example, Vermilion Energy Trust's participation in a partially-owned subsidiary "launched to capitalize on higher-risk properties previously held within the Trust and to enable Vermilion to participate in an exciting international junior exploration and production company."[44] Due to the need to create income, however, a trust will typically value the

[44] Vermilion Energy Trust, "Annual Report: 2004" (28 February 2005), online: SEDAR <www.sedar.com> at 3.

exploration plays lower as investors also tend to value more risk plays lower than those with known asset values.

C. TAX POOLS

Investors do not distinguish between distributions that are return of capital and those that are income. Accordingly, any value perceived related to tax pool is minimal and the purchaser that is a trust will pay little or nothing for such tax pools.

IV. IMPLICATIONS FOR THE OIL AND GAS LAWYER

By understanding the nature and structure of energy trusts and the way in which they seek to respond to investor objectives, we can now address how these factors affect oil and gas transactions in a way that is to a greater or lesser extent different than transactions in the context of traditional exploration and production companies.

A. ASSET TRANSACTIONS

1. ADDRESS THE HIGH VALUE ITEMS

Having regard for the key value drivers considered above, a practitioner should approach a transaction in a manner that ensures a trust buyer will receive all that it has assumed it would receive at the time it priced the transaction. This requires a focus on these key issues:

- the reserves to be acquired
- current and future production capacity
- revenues derived from transaction assets, including:
  - factors affecting commodity prices (in other words, long-term gas contracts or unutilized demand charges); and
  - access to markets.

2. DUE DILIGENCE

Whether prior to the execution of a binding purchase and sale agreement or in the interim period between execution and closing of the transaction, the lawyer can, together with appropriately skilled personnel from the client (or its outside consultants), assist in defining and undertaking the due diligence process. Having regard to the high value items to be addressed, the due diligence process should address the following matters.

a. Reserves

It is not the task of the lawyer to quantify or assess the quality of the reserves to be purchased by a trust, but the lawyer can endeavour to ensure that: (i) the purchaser is buying those reserves upon which it has based the purchase price; and (ii) the vendor actually owns the reserves it purports to be selling.

The former issue is usually satisfied by the ever-so-glamorous task of comparing the land schedule proposed to be included as part of the purchase agreement with the reserve (or similar) report used by the buyer in determining the price. There are occasions where such a review is not possible having regard for the size of such materials and the time permitted. In such circumstances, appropriate representations or covenants should be obtained and these are discussed below.

With respect to the latter issue, it is typical of Canadian practice that a vendor provide nominal assurances as to its title to the petroleum and natural gas rights being sold (usually the "by, through or under" representation). Thus a title opinion is used to mitigate the risk associated with a vendor not holding title or holding imperfect title to the sold assets.

b. Production and Revenues

Again, there is little a lawyer can do to assist in the assessment of the current and future productive capacity of the reserves to be acquired. That said, there is much a lawyer can do to assist the due diligence process by assessing the arrangements in place for the monetization of such production. Particularly with gas production, it may be a useful endeavour, together with marketing and accounting personnel, to ensure that the vendor's production records and revenues as reflected in accounting records are consistent with the underlying contractual arrangements.

It should not be sufficient due diligence simply to read through the marketing, transportation, and processing arrangements identified in a schedule to ensure that nothing untoward is found. Better practice would be for the lawyer to work with marketing and accounting personnel to confirm the value chain by ascertaining:

(1) Do recorded sales volumes match the production records used to price the acquisition (less appropriate adjustments)?

(2) Can the price realized for that production be confirmed by reference to both accounting records and underlying marketing agreements? Are these consistent?

(3) Can the costs incurred prior to sale (transportation and processing) as recorded in accounting records be confirmed with reference to underlying contractual documents?

(4) Are the revenues, net of expenses, consistent with purchaser's assumptions used when pricing the acquisition?

(5) Do the underlying agreements support the use of these assumptions over an expected term? Do key agreements expire, and if so, what are the implications?

Reading through marketing, transportation, and processing contracts and advising the client that they are consistent with those typically utilized in the industry may be sufficient to identify major deal breakers. This action, however, is unlikely to identify discrepancies between a purchaser's economic assumptions and a vendor's financial reality, discrepancies

that can, over the life of such arrangements, amount to a meaningful challenge to a buyer's economics.

The lawyer should also work with business personnel to ascertain what "inventories" (*e.g.*, product en route in pipelines or storage facilities) exist. The buyer should determine what typical linefill inventory is needed to operate.

c. Access to Markets

A sophisticated purchaser does not simply multiply production by commodity prices and discount the result as it sees appropriate. Instead, the due diligence process ought to assess actual production in the areas in which the production occurs, with regard not only to existing commodity sale contracts, but also the special circumstances that may ease or disrupt the ability to get such production to the point of sale. The due diligence process should include a determination as to whether the access of such production to markets has been or might forseeably be constrained, whether at a processing facility, on a pipeline, or at a point of sale. The role of the lawyer in this regard is to understand the key infrastructure utilized in getting production to market and to ensure that appropriate agreements are in place with terms that match the productive life of the reserves being acquired and that such arrangements will contemplate any production additions planned by the purchaser. Again, it may not be sufficient simply to review a gas processing agreement to ensure it is consistent with the Petroleum Joint Venture Association model forms of agreement. The better practice will be to understand the client's assumptions and its present and future needs and to ensure that the rights that it will be obtaining from the vendor are consistent with these assumptions and needs.

d. Security

The due diligence to be undertaken by a purchasing trust with respect to possible encumbrances on the acquired assets will likely be no different than the due diligence undertaken by a traditional exploration and production company in a similar transaction.

Where the vendor is a trust, however, the purchasing party ought to put its mind to claims or encumbrances against the assets that arise as a result of the trust structure. As noted elsewhere, there have been instances in which the trust has secured the obligations owed to it by the operating entity (whether in respect of a royalty or debt). Similarly, where financing has been undertaken at the trust level as opposed to the operating company level, the interest of lenders in assets owned by the operating company ought to be taken into account. As such, it is recommended that as part of the due diligence process, a purchaser's counsel conduct searches not just in respect of the operating entity, but also the trust and any affiliated trusts, corporate entities, or partnerships, and perhaps any corporate trustees, administrators, or managers.

3. REPRESENTATIONS AND WARRANTIES

a. Representations as to Trust Generally

Whether buying or selling, typically a "trust transaction" is undertaken through the operating entity and, to that extent, no unique issues arise solely because the operating entity is affiliated with a trust. On the other hand, there are a number of instances where the trust itself may be a counterparty to a transaction agreement. These might include: (i) a guarantee of the obligations of the operating entity; and (ii) agreements terminating, amending, or otherwise dealing with the general trust documents to the extent they affect the subject assets. In such circumstances, it may be appropriate to obtain from the operating entity or the trust itself (through the trustees) representations as to the trust and agreements to which the trust is a party. In these cases, counsel for the vendor will need to put his or her mind to what representations may be made with respect to the trust party.

Perhaps because of the relative absence of case law and statutes, legal counsel seem to be cautious in providing advice as to the representations a trust party can make (with respect to matters such as due formation, existence, and enforceability). For example, where a trust guarantees the obligations of the operating entity, it would be common for the counterparty to seek a representation that the trust has been duly formed and is validly subsisting, and that the obligations of the guarantee are enforceable against it in accordance with its terms. Such a representation might be easy to make in the context of a traditional corporation; however, in the context of a trust, such a representation may require qualification to address matters relating to the role of the trustees and the scope of the property which is subject to the trust relationship. The specific terms of the trust indenture must be carefully reviewed to determine if the granting of a guarantee or a particular action is authorized in the trust indentures. Unlike a corporation, where statute sets out the powers of a corporate entity, in the case of a trust all rights and powers are limited to the trust indenture. The *Trustee Act* does not give any assistance in this regard.[45]

b. Representations as to Assets

Where a trust is concerned, the purchaser will require a representation as to the extent to which the assets are encumbered or otherwise affected by the agreements forming part of the trust structure. A counterparty may choose to rely solely on the representations of the operating entity; however, there is a case to be made that obtaining a representation from the trust (as to any claims the trust has on the assets) is appropriate. Representations may relate to the applicability of the royalty or NPI (and there being no other such encumbrance). As discussed elsewhere, there are circumstances in which the royalty obligation payable by the operating entity to the trust is secured. Similarly, obligations with respect to production and marketing, management, or the assignment of property to which the royalty is subject may specifically relate to the subject assets (and perhaps, though arguable, seek to form an interest in any real property interests subject to the sale). The purchasing party may seek a representation not just from the operating entity, but also the trust as to the scope of such arrangements so that they can be adequately dealt with prior to or at closing.

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[45] *Supra* note 26.

Where a "concurrent" transaction is undertaken — a sale by the operating entity of the working interest and a concurrent sale of the royalty by the trust — it may be appropriate to obtain representations from the trustees, though the nature of the trustees may render this impossible.

c. Representations from Third Parties

There are a number of trusts where the manager/administrator of the trust is a different entity than the "operating entity," which holds title to the trust. In these cases, the counterparty may seek representations from such manager/administrator, as the manager/administrator may have knowledge of the assets. The manager/administrator's role, however, may have been solely one of service provider and may have little or no financial wherewithal. While it may have the knowledge, the value of the representation may be limited in that the manager/administrator may be unable to stand behind any liabilities flowing from a breach of the representation. If the manager/administrator is agreeable, the counterparty may seek the representation from the manager/administrator, the breach of which gives rise to liability of the operating entity or trust. This could be achieved by a cross-default mechanism or guarantee.

From the manager/administrator's perspective, however, it may see itself as a mere service provider who has not derived any value from the assets beyond its fees. Particularly where the manager/administrator is not wholly affiliated with the trust, there may be insufficient financial incentive to take on the liability associated with a representation. To facilitate the transaction, the manager/administrator may be prepared to make the representation provided it is indemnified (perhaps in the absence of gross negligence or willful misconduct) by the operating entity or trust.

4. COVENANTS

a. Guarantees

The extent to which a guarantee by the trust of the obligations of its subsidiary operating entity has or will become common practice is unclear, though it is not unheard of and does require consideration.

Complicating the issue is the nature of the royalty, NPI, or debt obligation arising between the trust and the operating entity. These documents make the trust a creditor of the operating entity. To the counterparty of the operating entity, the trust, though affiliated with the operating entity, does pose the possibility of a competing claim where the operating entity is unable to meet all of its obligations.

As a result, the counterparty to the operating entity may seek a guarantee or subordination to ensure that, where the operating entity is unable to satisfy all of its obligations to competing claimants as between the trust and the counterparty, the counterparty would prevail. This might take the form of a guarantee by the trust or a covenant that any claim by the trust would be subordinate to that of the counterparty. Some of these concepts are discussed more fully below. Again, all of these matters may be limited by the particular

provisions of the trust indenture. If the trust indenture precludes any such guarantee or subordination, the vendor or purchaser may have limited alternatives.

There appears to have been some evolution in trust structuring that makes these arrangements possible. Earlier trusts seem to have been more restricted by their underlying formative documents (the trust indenture) as to what sorts of assurances the trust might provide. As the industry evolves, trusts seem to have a greater scope in the type of obligations they can undertake in connection with the business of the trusts. That said, certain trusts may continue to be restricted as to the type of obligations they can take on.

b. Existing Trust Arrangements

When acquiring assets from a trust, it will be necessary to ensure that certain contractual arrangements in place under the trust structure terminate effective upon the sale. In that regard, the practitioner should consider the following:

(i) Termination of the Royalty/NPI

We are not aware of any royalties or NPIs in the context of an energy trust where the royalty or profits interest are stated to be or are intended to be interests in land. Indeed, most instruments giving rise to the royalty/NPI expressly state the interest is not an interest in land. Nevertheless, it is important for the purchaser to ensure that the assets being acquired are free from any claim by the trust under such arrangements.

In the past, there had been some practice to undertake a "concurrent sale" of both the working interest and royalty interest. In this arrangement, the purchaser acquired the working interest from the operating entity and the royalty or NPI from the trust in concurrent transactions. Upon the purchase, the interests merged vesting with the purchaser's clear title to the working interest. Such concurrent sale arrangements do not appear to be used in the current environment.

As the purchaser is to take the benefit of the assets as of the effective date, it would be preferable from the purchaser's perspective for the royalty to be terminated on that date. If there is an extended period between the effective date and the closing date, however, this might leave revenue attributable to the operating entity in a manner which results in tax being paid in the hands of the operating entity. The parties need to consider this with tax advisors to ensure that the purchaser is receiving the benefit of the property absent the royalty from and after the effective date in a manner which does not create a taxable situation for the operating entity. This might be accomplished by keeping the royalty in effect until the closing date, and providing for a negative adjustment to the purchase price for any royalty paid between the effective date and the closing date.

(ii) Management/Services/Administration Agreements

As noted above, it may well be necessary to maintain these types of service arrangements in place until the closing date to ensure the ongoing operation of the assets prior to closing. By doing so, however, corresponding issues arise. First, while it would be appropriate for the

operating entity (or other managing entity) to recover some amount in respect of general and administrative costs in connection with the operation of the assets, the purchaser may be unwilling to pay the amount required under the applicable agreements to the extent they exceed that which might ordinarily apply to the operation of the assets.

As an example, a management or marketing agreement may be required until the time of closing to ensure the continuous operation of the assets. At the same time, the agreements pursuant to which these services are provided may provide for fees which include a profit component or which exceed the fair market value of the services being provided. In such circumstances, it may not be appropriate for the vendor to retain the full amount payable in respect of the sold assets during the interim period. Specific accommodations may be necessary to ensure that the requisite services are provided at a cost which reflects the fact that the benefit of ownership from and after the effective time is to rest with the purchaser.

Second, where the party managing or operating the assets is a different party than the operating entity that holds title to the assets, the purchaser will require a covenant not just from the operating entity, but also from the manager/administrator that: (i) the assets will be operated until the closing date (and what the cost will be of doing so, in other words, for the amount prescribed by or different than the underlying agreements); and (ii) the underlying agreements will be terminated with respect to the assets on the closing date.

(iii) Other Related Agreements

The structure of a trust and, in particular, arrangements put in place at the time the trust was created, often give rise to agreements which might not typically be seen in respect of very similar assets when held by a traditional exploration and production company.[46] The situation seems more prevalent in cases of trust conversions where the resulting exploreco and trust entity share management, infrastructure, access to markets, or key stakeholders.

Where such non-arm's length agreements may affect assets being purchased from a trust, the purchaser and its counsel will need to consider the manner in which these tentacles will be removed from the assets at the time of the sale. At the very least, a warranty that the assets and the purchaser will be free of any obligations arising from these types of agreements and a covenant that the vendor will do all things necessary to honour such a warranty would be appropriate. Consider also obtaining from the counterparties to such an agreement (where different than the operating entity) a corresponding obligation to terminate.

[46] See *e.g.*, the material agreements described in the Calpine Natural Gas Trust AIF, *supra* note 21. Included in these agreements are a Governance Agreement, a Services Agreement, a Pre-emptive Rights Agreement, a Participation Agreement, a Call on Production Agreement, and an Energy Management Services Agreement. It is not clear, on the face of publicly available information, which if any of these agreements would have directly affected an asset being sold and, where applicable, the manner in which the vendor and purchaser would need to make specific accommodations.

B. THREE-PARTY AND BACK-TO-BACK DEALS

It is becoming increasingly common, in connection with large asset dispositions in particular, that the acquired assets be split between a trust and a non-trust entity.[47] The attraction of such an arrangement is that the trust entity can acquire those assets that best fit into its model (revenue generation), whereas the traditional exploration and production company would acquire assets that better fit into its more risk-tolerant or capital-intensive portfolio.

If such dispositions are undertaken through two separate transactions, there is little to consider within the scope of this article beyond that already discussed. However, it is common in such circumstances for one party (the "intermediate party") to deal with the vending entity and re-sell a subset of the acquired interests to a third party. This situation gives rise to certain difficulties, especially for counsel to the intermediate party. As it gains no economic benefit from the re-sold assets, it ought not to take any liability in respect of those assets, whether *vis-à-vis* the original vending party or third parties. To alleviate these risks, the intermediate party and second purchasing party will typically:

- endeavour, subject to confidentiality obligations, to have the second acquiring party follow and provide comment on matters such as representations and warranties during the negotiation process with the vending party;

- include conditions to closing which are aligned such that the intermediate party has no obligation to close with the subsequent purchaser unless the initial purchase closes but does require the second purchaser to close if the first transaction closes;

- have the intermediate party offer only representations and warranties to the second purchaser that are consistent with (if not exactly the same as) those received by it from the vending party;

- have the second purchaser provide a full indemnity to the intermediate party in respect of the resold assets; and

- in the second transaction have an effective date the same as and the closing date immediately after that set forth in the initial purchase so as to eliminate the attribution of any revenues or expenses for tax purposes in the hands of the intermediate party.

Those matters are relatively straightforward. What requires more consideration are less obvious matters with the potential to affect the intermediate party's position adversely. For example, it is common for a threshold or deductible to apply to the liability of a vending party under an asset sale transaction. As the first sale from the vending party to the

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[47] See e.g., the 2004 purchase by Enerplus Commercial Trust from Chevron Canada Western Partnership, and subsequent resale to Paramount Resources Ltd. as described at "Paramount Resources Ltd. Completes Acquisition of Oil and Gas Properties" (30 June 2004), online: Paramount Resources Ltd. <http://cnrp.ccnmatthews.com/client/paramount_resources/release.jsp?year=2004&actionFor=464261&releaseSeq=13>.

intermediate party is of greater value, it would make sense for these thresholds and/or deductibles to be higher than those that would ordinarily apply to the second transaction. The inclusion of any threshold or deductible in the second sale would create exposure for the intermediate party in respect of assets from which it derived no value. If the parties were to address this by the intermediate party having no liability beyond that which it can collect from the initial vending party, the result would be that the second purchaser essentially lives with the higher deductibles and thresholds applicable under the first agreement. On the other hand, the intermediate party is happy to "use" the value of the second purchaser's claims as against the deductibles and thresholds where the intermediate purchaser has its own claims which, on their own, do not exceed the deductible and/or threshold. This has some value to the intermediate party for which, presumably, it received no real consideration.

The different approaches of energy trusts and traditional exploration and production companies will continue to result in transactions where these issues arise. The practitioner needs to ensure that he or she fully considers and adequately addresses the special circumstances that arise in connection with these "back-to-back" transactions.

C. COUNTERPARTY CONCERNS

The nature of a trust gives rise to unique issues when considering the rights and remedies of a counterparty. As discussed above, the typical trust has the operating entity pay by way of royalty or NPI almost all of the available cash flow to the trust. The trust then distributes that cash almost immediately to its unitholders. In many instances, the cash situation of the operating entity and trust, taken together, amount to little more than working capital and the current month's cash flow. Counterparties to a transaction with a trust entity may have a legitimate concern as to their ability to look to the operating entity (or the trust under a guarantee) to support its contractual obligations.

This issue arises whether the trust entity is the purchaser or the vendor. Where it is the purchaser, the counterparty will be looking to it to stand behind obligations such as the environmental indemnity. Where the trust entity is the vendor, the purchaser will need to be comfortable that it has an effective remedy should any of the representations, warranties, or covenants be untrue or otherwise not satisfied.

As discussed above, the counterparty may seek a guarantee or subordination from the trust. While this may ensure priority over a claim by the trust against the operating entity, it does not address the more general issue as to the ability of the trust entity to stand behind its obligations.

This issue should not be overstated. Assuming the counterparty has obtained the guarantee or subordination from the trust, the counterparty is likely in a very similar position as it would have been had it dealt with a non-trust entity (aside from the trust entity's general practice of distributing cash flow as it becomes available). If the counterparty were to enforce rights against the operating entity, it could take action to prevent the distribution to the trust of cash flow until such time as the obligations were satisfied (note, however, the different status of a trust *vis-à-vis* insolvency legislation as discussed elsewhere.)

In addition, the royalty or NPI creating the obligation between the operating entity and the trust will typically provide for the distribution of cash after meeting all of the operating entity's obligations. In this manner, the terms of the royalty itself may ensure that obligations to the counterparty are met before the funds are distributed. With respect to this point, however, the trust entity may be hard pressed to have the counterparty assess with certainty this result (why should the counterparty pay its lawyer to opine upon the workings of the trust's royalty?) and may instead seek assurances from the counterparty and the trust that, where the trust entity is unable to meet its obligations to the counterparty, distributions will not occur until such time as the obligations are satisfied.

These are the sorts of covenants utilized by lenders when dealing with a trust. The counterparty to a trust transaction ought to consider whether, having regard to the totality of the associated risks, it requires protection beyond what it would normally seek in respect of an exploration and production company in similar circumstances and, if so, the extent to which it can address these concerns in a manner similar to the way in which a lender does.

V. EVOLVING ISSUES

A number of basic issues remain unresolved with respect to income trusts. Several of the key concerns will be briefly outlined below.

A. LIABILITY OF TRUSTEE AND UNITHOLDERS

In an action against a corporation, shareholders are shielded from liability by the corporation's status as a legal person. Although courts may, in some situations, look past the separate corporate personality, this happens only in unusual cases and large institutional investors can be reasonably assured that under normal circumstances they face no potential liability from investing in a corporation.

Regarding trusts, there has been much discussion as to the potential liability for unitholders and recent legislative changes may be resolving that uncertainty. Typically the trust indenture would provide that the unitholders of the trust would not be subject to any liability in connection with the trust or its obligations and affairs. Even where a court might determine unitholders were subject to an obligation or liability, the trust indenture usually attempts to provide that the obligations would only be satisfied out of the trust's assets. The trust indenture might go so far as to require the trustees, in entering into an agreement on behalf of the trust, to include a provision such as the following:

> The parties hereto acknowledge that the Trustee is entering into this agreement solely in its capacity as Trustee on behalf of the Trust and the obligations of the Trust hereunder shall not be personally binding upon the Trustee, any of the Unitholders of the Trust or any annuitant under a plan of which a Unitholder is a trustee or carrier (an "annuitant") and that any recourse against the Trust, the Trustee, any Unitholder or annuitant in any manner in respect of any indebtedness, obligation or liability of the Trust arising hereunder or arising in connection herewith or from the matters to which this agreement relates, if any, including without limitation claims based on negligence or otherwise tortuous behaviour, shall be limited to, and satisfied only out of, the Trust Property as defined in the Trust Indenture.

Most counterparties, understanding the nature of the trust and their increasingly important role in the industry, were able to accommodate such a request. In the absence of such a contractual limitation, however, there was some uncertainty as to the potential liability of unitholders personally. It became necessary for trusts to caution potential unitholders of this hypothetical liability along the lines of the following:

> Although the operating entity will use reasonable efforts to have any contractual obligations modified so as not to have such obligations binding upon any of the Unitholders personally, it may not obtain such modification in all cases. To the extent that any claims under such contracts are not satisfied by the Trust, there is a risk that a Unitholder may be held personally liable for obligations of the Trust where the liability is not disavowed as described above. Notwithstanding the terms of the Trust Indenture, Unitholders may not be protected from liabilities of the Trust to the same extent as a shareholder is protected from the liabilities of a corporation. Personal liability may also arise in respect of claims against the Trust (to the extent that claims are not satisfied by the Trust assets) that do not arise under contract, including claims in tort, claims for taxes and other possible statutory liabilities. It is intended that the activities of the Trust will be conducted, with the advice of counsel, in such a way and in such jurisdictions as to avoid, so far as possible, to the extent they deem practicable any material risk of liability on the Unitholders for claims against the Trust.

Recent legislative changes, such as the passage of the Alberta *Income Trusts Liability Act*[48] and the Ontario *Trust Beneficiaries' Liability Act*,[49] provide statutory protection to unitholders of trusts created pursuant to the laws of those provinces. As a result, trusts are revising the caution presented to potential investors. From a recent prospectus:

> On July 1, 2004 the *Income Trusts Liability Act* (Alberta) came into force, creating a statutory limitation on the liability of unitholders of Alberta income trusts such as the Trust. The legislation provides that a unitholder will not be, as a beneficiary, liable for any act, default, obligation or liability of the trustee that arises after July 1, 2004.
>
> ...
>
> The Trust Indenture provides that no Unitholder will be subject to any liability in connection with the Trust or its obligations and affairs and, in the event that a court determines Unitholders are subject to any such liabilities, the liabilities will be enforceable only against, and will be satisfied only out of the Trust's assets. Pursuant to the Trust Indenture, the Trust will indemnify and hold harmless each Unitholder from any costs, damages, liabilities, expenses, charges and losses suffered by a Unitholder resulting from or arising out of such Unitholder not having such limited liability.[50]

It is hoped that the legislative changes will eliminate the potential liability of unitholders and it appears that institutional investors have accepted this to be the case in those jurisdictions in which the legislation has been passed. Nevertheless, many trusts will continue to be contractually obliged, pursuant to their trust indenture, to use reasonable efforts to have the limited liability language included in their agreements. It is unclear

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48 S.A. 2004, c. I-1.5.

49 S.O. 2004, c. 29, Sch. A.

50 See Starpoint Energy Trust, "Short Form Prospectus" (filed 3 February 2005), online: SEDAR <www.sedar.com> at 11, 27.

whether industry will err on the cautious side and include such limitation language notwithstanding that it may not be necessary having regard to the new legislation (but in compliance with the trust indenture) or interpret the trust indenture so as not to require such language be included in jurisdictions where the limiting laws have been enacted.

B. FOREIGN OWNERSHIP OF UNITS

In the 2004 federal budget, additional restrictions relating to the level of non-resident unitholders of a mutual fund trust were proposed. While these provisions were not implemented, there continues to be discussion among trust groups and the federal government regarding the appropriate limitation on non-resident ownership and taxation levels. Currently, there is a 15-percent withholding tax on all distributions, whether by way of a return of capital or income, to non-resident unitholders. Industry groups argue that this level of taxation is sufficient for the federal government to recover any perceived or actual "tax leakage" to non-resident Canadian unitholders. Accordingly, the groups argue that no restriction on the holdings of units in a trust should apply. Given the uncertainty surrounding this issue, there has been some hesitancy to seek further investment from outside of Canada. Given the limited size of the Canadian capital market, this result will impact the size and nature of the transactions that trusts may be able to complete. For example, any entity that would require approximately $1 billion or more of new equity may be hesitant to proceed with a transaction without the ability to purchase the assets in two stages, thereby allowing more time to obtain the appropriate capital in Canada. Conversely, an entity that is considering a conversion to a trust will need to consider its current shareholder base to determine if more than 50 percent of the shares are held by non-resident Canadians. As there is no system to properly monitor residency of shareholders on a real-time basis, the closer that an entity's shareholding position is to the 50 percent mark, the less likely that entity will convert into a trust due to the catastrophic results that would occur should they exceed the federal government's level of allowable foreign ownership in a mutual fund trust. There are potential means by which royalty trusts that have 90 percent of the trust's assets in "non-taxable Canadian property" may currently exceed the 50 percent ownership test. However, careful discussion with tax advisors must be undertaken if there is a possibility that the level of non-resident Canadian shareholders will be 40 percent or more.

C. OWNERSHIP OF FOREIGN PROPERTY

Trusts that can be included in registered retirement savings plans, registered retirement income funds, and deferred profit sharing plans (exempt plans) are particularly attractive to investors. Part XI of the *Income Tax Act*[51] provides for a tax where the cost amount of an exempt plan's foreign property exceeds 30 percent of the cost amount of all properties held by the exempt plan. It was for this reason that many trust structures included a top trust, the beneficiaries of which were the unitholders, and a subsidiary trust (the commercial trust), which owned the operating entity or interest in the subsidiary partnership. Though it was possible to ensure that such arrangements did not constitute foreign property by making it a registered investment, doing so had its own adverse tax consequences.

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[51] *Supra* note 17, s. 206(2).

In its 23 February 2005 budget, the Government of Canada proposed the elimination of the limit on the amount of foreign property that could be held in exempt plans. At the time of writing, this had not yet been put into effect.

D. GOVERNANCE AND UNITHOLDER RIGHTS

Unlike a business corporation, which is subject to the requirements of the *Business Corporations Act* (or similar legislation applicable in its jurisdiction of incorporation), the establishment of a trust, the nature of its structure, and the rights of its beneficiaries are not prescribed by legislation. Instead, a trust is a creature of the trust indenture pursuant to which it was settled.

The *Business Corporations Act* (or similar legislation) sets forth the manner in which a corporation's directors are elected, the right of shareholders to call or attend meetings, and matters which require shareholder approval.[52] Similarly, it is customary for a trust's indenture to set forth the manner in which trustees are appointed, the requirements for meetings of unitholders and matters in respect of which unitholder approval is required. Governance provisions could be introduced to deal with such areas as trustee duties, appointment of trustees, officers and auditors, unitholder meetings, dissolution provisions, voting rights, reorganizations, derivative actions, classes of units, and distributions. Such obligations are contractual rather than statutory in nature, and while this gives great flexibility in terms of structure, it also raises concerns about unitholder protection.

We are aware of only one Canadian case considering the governance of income trusts, *RioCan Real Estate Investment Trust v. RealFund*.[53] The parties, which were both income trusts, agreed that the principles applying to boards of directors and shareholders in a corporate context should apply by analogy to an application to enforce a unitholder's requisition for a unitholders meeting. Blair J. did not explicitly endorse this approach, but acknowledged that as it is an important protection against the conduct of directors for shareholders to call meetings, so it should be a protection for unitholders of a trust against the conduct of trustees.

While undoubtedly future case law will provide guidance as to trust governance matters, it is more likely that unitholder rights with respect to governance of trusts will develop by statute, or in some cases, through regulation by Securities Commissions. For instance, several jurisdictions in the U.S. have enacted legislation granting the same limited liability to unitholders as is available to shareholders of corporations and setting the standard of care of trustees as equivalent to the standard of care of directors.[54]

While there is currently no Canadian legislative scheme which applies specifically to the structure or activities of income trusts, trusts that are publicly traded are subject to applicable securities legislation and trusts and their trustees must abide these requirements. In addition

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[52] *Canada Business Corporations Act*, *supra* note 29.

[53] (1999), 95 O.T.C. 269 (Sup. Ct. J.).

[54] Joseph Groia & Diana Iannette, "Income trusts" (26-27 February 2003) at 3, online: *in*Conference <http://inconference.insightinfo.com>.

to NP 41-201, a number of guidelines and policies applicable to public issuers specifically or implicitly affect the governance of trusts and offer protections to unitholders similar to those applicable to corporate shareholders.[55] As an example, while a trust indenture (rather than the *Business Corporations Act*) will set forth when a meeting of unitholders is to be held and the matters in respect of which unitholder approval is required, applicable securities legislation (and related policies and instruments) apply to the form and distribution of proxy circulars.

While securities legislation of general application and certain policies and instruments do apply to income trusts, the area of governance and unitholder rights is clearly an evolving area and practitioners will need to keep abreast of changes to ensure advice to clients reflects the most recent developments. As an example, the Alberta Government indicated in July 2004 a concern as to whether the then-current definition of "insider" under provincial securities legislation adequately described those who might be in possession of material information about a reporting issuer trust. For example, the definition does not extend to a vendor who retains an interest in the trust's underlying business and provides related management services to the trust.[56] As a result, the Alberta *Securities Act*[57] was amended to revise the definition of an "insider" in the context of an income trust. This was one of many concerns that had been identified relating to governance of trusts that had not been addressed by regulatory instrument, statute, or case law and is among the first examples of a statutory response to the issue.

Since the primary attraction of trusts seems to be their tax treatment, some commentators have suggested that the best approach to governance concerns would be to cease taxing corporations on income distributed as dividends to shareholders.[58] Other commentators feel that governance need not be a concern. Professor Flannigan has suggested that the passivity of business trust investors and the fiduciary obligation and open liability of trustees justifies the absence of an extensive regulatory scheme.[59] Although trusts would not be affected by any amendments to provincial or federal business corporations acts, guidelines and policies adopted by securities commissions will ensure that trusts are held to the same governance standards as other public issuers.[60] Some institutional investors have indicated that they will not focus on governance concerns relating to income trusts until the issue of unitholder liability has been addressed.[61] The introduction of the Alberta *Income Trusts Liability Act* and the Ontario *Trust Beneficiaries' Liability Act* may therefore switch investor attention away from this traditional concern and encourage discussion of other concerns, such as those relating to governance. A quick survey of the largest capitalized trusts indicates a general comfort in the governance of a large-cap trust so, in fact, this issue may be of overstated importance.

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55 NP 41-201, *supra* note 14. Including, *inter alia*, National Instruments, Multilateral Instruments, and National Policies, 58-201, 58-101, 51-102, 52-109, and 52-110.

56 *Income Trusts*, *supra* note 1 at 7.

57 R.S.A. 2000, c. S-4, s. 5.

58 Mark Gillen & Michelle Moriartey, "Reducing Double Taxation First Response on Income Trust Governance" *The Lawyers Weekly* 24:27 (19 November 2004) (QL).

59 Flannigan, *supra* note 27 at 636.

60 Andy Holloway, "Trusty Trusts?" *Canadian Business* 77:14/15 (19 July-15 August 2004) 75 (ProQuest).

61 Gary Marr, "Liability still top trust issue, Wilson says, Conflicts also a concern" *National Post* (29 September 2004) IN.3 (ProQuest).

E. BANKRUPTCY AND INSOLVENCY

The *Bankruptcy and Insolvency Act*[62] and the *Companies Creditors Arrangement Act*[63] allow entities in financial difficulty to stay their creditors long enough to restructure and ideally regain some kind of financial footing. Neither *Act* may be said to apply to trusts, which are neither companies nor any other sort of legal person. This leads to the conclusion that trusts in and of themselves are not subject to restructuring proceedings. In practice, bankruptcy and insolvency of trusts must be dealt with at the operating entity level, since operating entities are for the most part corporations or partnerships that may be dealt with under these two *Acts*. The fact that formal restructuring proceedings are not available to a trust is usually noted in the trust's prospectus or other disclosure documents. However, the Alberta Government suggested that it might be desirable to address this gap in the legislative scheme, and the Standing Senate Committee on Banking, Trade and Commerce recommended in November 2003 that the *BIA* and *CCAA* be amended to provide for liquidation or reorganization of income trusts.[64]

VI. CONCLUSIONS

Trust structures have been used in the energy industry since the mid-1980s. The nature of oil and gas operations makes businesses in this sector ideal candidates for conversion to a trust. A variety of structures are available to the potential trust, including trusts on top of corporations owing royalties or debt to the trust and trusts on top of partnerships, usually through an intervening commercial trust. The structure decided on by each individual trust will be dictated by concerns for tax efficiency and governance/management issues. Trusts will continue to be popular investments, especially with retail investors, largely because of their predictable high rate of return.

It is within this context that the oil and gas lawyer will increasingly practice. While to a great extent the issues that arise in the context of a transaction involving a trust are similar to those involving two "ordinary" exploration and production companies, there are differences that require extra consideration to ensure the client's objectives are attained and risks mitigated.

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62 R.S.C. 1985, c. B-3 [*BIA*].
63 R.S.C. 1985, c. C-36 [*CCAA*]
64 *Income Trusts*, *supra* note 1 at 10.