Governance Challenges for Income Trusts

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I. Introduction

Corporate governance continues to be a hot topic. In Canada, we are at the stage of implementing a number of initiatives that have been enacted to follow the US lead in the Sarbanes-Oxley legislation. The rules relating to audit committee composition and function, and certification of periodic filings, have been in force for some time. The most recent round of changes, which formalize the governance guidelines in a National Instrument promulgated by the CSA, applies to the first year-end of issuers falling after June 30, 2005. We will therefore see responsive disclosure for most issuers in the annual documents filed in the first two months of 2006 for issuers with a December 31 year-end. (This will include income trusts, since under the *Income Tax Act* the tax year-end of all trusts is December 31.)

The application of corporate governance requirements to income trusts has been a matter of debate. Until recently, regulation of corporate governance issues in Canada was undertaken by the *Toronto Stock Exchange* ("TSX") under a model that was mainly a matter of exhortation, the only mandatory requirement of which was that issuers address their approach to corporate governance in their annual proxy circular. There was no mechanism for enforcement of this modest requirement (short of delisting), since the TSX has no functional means to require issuers to modify their annual disclosure documents filed in accordance with securities legislative requirements. Furthermore, even this modest requirement was not directly applied to income trusts.

Perhaps in part because of this, there appears to be a perception that income trusts do not do as good a job with governance as regular corporations. On October 17th and 18th, the Globe and Mail announced the results of its annual corporate governance study on corporations. It followed on October 19th with a more summary piece on income funds, which commenced with the following comment:

> "Canada's larges income trusts may have the heft to play in the benchmark index majors, but when it comes to corporate governance practices, they are still in the minor leagues."

It should be noted that a number of the benchmarks used by the Globe and Mail's survey to assess issuers are not found in the securities regulatory requirements. These include whether two-third of the trustees (rather than a majority) are "independent" whether the trustees are eligible for options, gender representation on the board, and whether voting for individual directors (as opposed to slate voting) is permitted. It will not be possible to assess how well income trusts meet securities regulatory requirements until the first round of reporting is completed in 2006. If they have the resources to do it, I expect that the securities regulatory authorities will publish commentary on the adequacy of disclosure by income funds as compared to corporate issuers. Until that happens, commentary such as that contained in the Globe and Mail article can fairly be described as anecdotal evidence, but even so, will tend to have a significant effect on investors' perception of income trusts.

II. Recent and Proposed Governance Changes

The first regulatory changes that came into force in Canada in response to US initiatives concerned audit committees and certification of periodic filings. These were adopted by Multilateral Instruments 52-109 and 52-110. (These are Multilateral rather than National Instruments because British Columbia declined to adopt them.) They mandate an Audit Committee, its composition and function, and the certification of interim and annual filings by responsible officers under the oversight of the Audit Committee. Related requirements concerning the design and adoption of internal control systems are pending but are still under consideration.

The securities commissions have now taken over responsibility for corporate governance standards by the promulgation of National Instrument 58-101 "Disclosure of Corporate Governance Practices", and Companion National Policy 58-201 "Corporate Governance

Guidelines". (These two documents are referred in this paper as the "Governance Regulation".) Under this new regime, the situation faced by income trusts has changed in a number of ways.

(i) While the corporate governance standards articulated in the Governance Regulation are broadly the same as those which have been promulgated by the TSX for a number of years, a number of specific disclosures are now required by Form 58-101F1.

(ii) The securities regulatory authorities have the means to ensure compliance with the requirements of the Governance Regulation, such as requiring issuers to change disclosure in future filings or even re-file earlier filings.

(iii) The Governance Regulation expressly applies to income trusts, as manifested in the following comment:

> "Income trust issuers must provide disclosure in a manner which recognizes that certain functions of a corporate issuer, its board and its management may be performed by any or all of the trustees, the board or management of a subsidiary of the trust, or the board, management or employees of a management company. In the case of an income trust, reference to "the issuer" refer to both the trust and the underlying entities, including the operating entity."

For many income trusts, these changes will not be momentous. Most income trusts that have gone public since 2002, which includes a majority of business trusts, adopted committee structures, committee charters and an overall approach to governance that mirrored the approach taken by corporations. They did so at the urging of the underwriting syndicates that brought the trusts to market, since those syndicates recognized the groundswell of concern about governance and that investors needed reassurance that income trusts were taking the matter seriously. Furthermore, many income trusts have adopted the pattern of reporting in detail in their proxy circular on the manner in which they seek to achieve the objectives set out in the TSX guidelines. In doing so, some income trust issuers have put the emphasis on the operating entity. On the surface, therefore, there may not be a significant change in the disclosure practices of many income funds as a result of the enactment of the Governance Regulation.

Beneath the surface however, at least some income trusts face significant governance challenges beyond those faced by regular corporations. Some trusts, for example the restaurant royalty funds, do not own or control the underlying business on which unitholders are dependent for their distributions. They are therefore limited in their ability to accept the cornerstone responsibility recommended by the Governance Regulation, which is the explicit acknowledgment of responsibility for the stewardship of the issuer, including responsibility for:

- adopting a strategic planning process;
- approving a strategic plan which takes into account the opportunities and risks of the business;
- identifying the principal risk involved in the business;
- ensuring the implementation of appropriate systems to manage those risks.

It is also beyond the powers of the funds themselves to direct with respect to the underlying business the nature of internal control and audit assurance measures to be adopted by the operating entity.

Other funds (mainly of the pre-2002 vintage) indirectly own the underlying business but still operate with external management. Depending on the level of control of the operating entity that is vested in the manager, this may leave the trustees in a similar position of being unable (in their capacity as trustees) to assume stewardship for the underlying business, and can also create some difficulty concerning internal and audit controls.

The issue of audit controls is compounded in these non-controlled or partially controlled situations by the introduction of accounting for Variable Interest Entities. Since the start of 2004 it has been necessary for income trusts to consolidate uncontrolled entities where the trust bears substantially the whole financial risk of the enterprise. A common response to the corporate scandals of the last five years has been to put a greater emphasis on the published financial statements of public issuers, their preparation and the assurance function relating thereto. Since the published financials are those of the income trust, it is hard for trustees to disavow responsibility for internal control and assurance in the "subsidiary" entities. If the trustees do not form a majority of the board of the subsidiary entity, however, there is some disconnect between their responsibilities and the means to fulfill them.

In many instances, the trustees of an income trust are the same as the directors of the operating subsidiary entity (a subsidiary company, or the general partner of a subsidiary partnership). On the surface therefore, the trustees can accept a greater degree of responsibility for the matters at which the Governance Regulation are aimed. Even then, as discussed further below, the *Income Tax Act* provides (at least) a theoretical obstacle to the trustees fully embracing the overall objectives of the Governance Regulation.

III. Institutional Scrutiny and Accountability

While it is impossible to substantiate empirically, many contend that the improvement in corporate governance practices is attributable, at least in part, to the scrutiny provided by institutional investors. If that is so, one reason for the perception that the governance of income trusts is lagging may be that many institutional investors have been slow to accept income trusts as an appropriate form of investment. In the October 19th Globe and Mail article referred to above, the comment is made that institutional "shareholders" are having more influence on trust boards. However, the comment is also made that the Globe and Mail review covered only 15 of the biggest trusts, and indicated relatively mediocre results, so that by extrapolation, there ought to be concern about the governance of smaller trusts. If the institutions restrict their following of income trusts to those that are included in the index, and thus have little influence on smaller trusts, it may be unduly hopeful to look to the institutions to improve governance of income trusts generally. In reflecting on these matters, one should also bear in mind last year's proposals from the Department of Finance to limit investment by pension funds in income trusts. An artificially reduced weighting of institutional investment in income trusts, and a correspondingly higher weighting of individual investors, may continue to slow enhancement in the governance practices of income trusts.

There are aspects of trust structures which, on analysis, resemble features of corporate securities that many institutional investors have traditional shunned. Institutional investors have often avoided investing in non-voting or restricted voting stock. There are aspects of the structure of certain income trusts that mirror restricted voting arrangements, and may therefore be frowned on by institutional investors.

For example, in the case of the restaurant royalty trusts, the subsidiary entity of the trust does not own an operating business. It owns the trademarks and other intellectual property, which it licenses to the operating business in exchange for a royalty. The trust therefore does not own the operating business even indirectly, but has only a contractual right to receive royalty payments from the operating business, which continues to be privately owned and controlled. In the event of a downturn in the business, the subsidiary entity's only right is to ensure that it continues to receive the agreed percentage of the revenues of the operating business, but has no ability to "shake up" the business as long as the royalty payments are made. The role of the trustees, and of the directors of the subsidiary entity, is to manage the contractual relationship between the public entities and the private operating company. While the analogy is not complete, some investors may view the arrangement as being equivalent to holding a non-voting share in the operating business, which could be compared to a preferred share with participation rights.

A different structure exists in some of the income funds that were created before 2002. In the initial wave of income trusts, underwriters were concerned that the entity might be viewed as an "orphan", since in most cases the former owners entirely divested themselves of the business. To mitigate this, management contracts were entered into under which the former owners continued to provide some level of management services. Under a governance agreement, the management was often entitled to nominate either half or a majority of the directors of the subsidiary entity, with the other directors being trustees. The board of directors of the subsidiary entity is required to act in the best interests of the company, which is for the benefit of the income trust as the sole investor. Nonetheless the governance structure means that a majority of the board of directors of the operating entity are not elected by and are not otherwise directly accountable to the unitholders. Again, in this instance the trust units can be compared with non-voting or restricted voting securities, in this case on a fully participating basis.

There are other variations within income trust structures that either increase or decrease the level of accountability to unitholders. For example, upon creation the Fording Canadian Coal Trust owned all the shares of Fording Inc. The Fording Trust declaration of trust required the trustees of that trust to vote the shares of the subsidiary in favour of nominees to the board of directors of the subsidiary that are approved by more than 50% of the votes cast at the meeting of the trust's unitholders. One of the items of business at each annual meeting of unitholders was the selection of directors to be appointed by the trust to the board, which increased the level of accountability of those directors in their capacity as such to the unitholders of the trust. In addition, a majority of the directors of the subsidiary were not trustees of the income trust. The subsidiary entity is a 60% partner in a partnership of which another entity (Teck Corporation) is the managing partner. As a result, while the Fording structure provides greater accountability of directors to the public unitholders, the cornerstone tenet of the Governance Regulation, that the publicly elected board accept responsibility for the stewardship of the underlying business, is not met.

In many income trust structures, the trust owns and votes the equity interests in a corporation (which may be a general partner of a partnership), and the trustees of the trust and the board of directors of the corporation are the same individuals. (There is, however, no legal requirement that this be so.) Management of the subsidiary is accountable to the board of directors of the corporation. In such a structure, even though the individuals as trustees of the trust and directors of the corporation must keep their legal roles distinct, as a practical matter that same group of people is both accountable to the unitholders and responsible for the supervision of management of the business. Since income trusts have only one class of unit, which have voting rights, at a minimum this permits the unitholders to elect the trustees of the trust, who are the same individuals who have stewardship of the business. These features are consistent with the line of accountability that one would expect within a corporation, including with respect to such matters as management remuneration. In these structures the governance model may therefore be readily accepted by institutional investors.

IV. Inherent Governance Tensions

Most income trusts have managed to make the governance guidelines work on a practical basis. They have often done this by putting the focus on the subsidiary entity and conformity by its board of directors to the Governance Guidelines of the TSX. The approach of focusing on the subsidiary entity is sanctioned by the Governance Regulation.

There remains however a basic tension between the requirements of the *Income Tax Act* that govern income trusts and the tenets of corporate governance. Income trusts qualify as "mutual fund trusts" under the *Income Tax Act*. One of the requirements for qualification as a mutual fund trust, as set out in section 132(6)(b) of the *Income Tax Act*, is that the income trust's "only undertaking" is:

(i) the investing of its funds in property (other than real property or an interest in real property),

(ii) the acquiring, holding, maintaining, improving, leasing or managing of any real property (or interest in real property) that is capital property of the trust, or

(iii) any combination of the activities described in subparagraphs (i) and (ii).

The *Income Tax Act* also provides that a trust is to be taxed as an individual, and that references to trusts should be read to include a reference to the trustees. That being so, it may be necessary to read section 132(6)(b) as meaning that the trustees of an income trust must, in relation to the trust, restrict their undertaking to the investing of funds in property. This suggests a completely passive role for the trustees, and indeed in lay terms the requirement of section 132(6)(b) is often described as a requirement that the income trust "not have an active business".

The question this suggests is how passive the trustees must be. Business people and lawyers alike have not had much difficulty with the proposition that, even if the trustees restrict their undertaking to the ownership of property, including securities, they are entitled (indeed required) to exercise the incidents of ownership of that property. In the case of voting equity interests in a subsidiary entity, that includes the right and responsibility to ensure that the board of directors is properly constituted and that the subsidiary entity is being run properly. The limitation on the undertaking of the trustees has not been perceived to preclude them from serving as directors of the subsidiary entity, and by so doing fulfilling their stewardship functions. In addition, lawyers would stress the difference of function between the trustees of the trust and the directors of the corporation, and would argue that, even if the same individuals serve as directors of the corporation, the individuals have a distinct function as directors, and are not simply acting as trustees wearing another hat.

Even if one accepts all the foregoing, however, a dilemma remains. The current approach to corporate governance emphasizes accountability of the elected board of directors to the security holders, and underscores that by linking the board's performance in a number of areas to the question of their re-election. It is for this reason that the document that will be required to contain the disclosure set out in Form 58-101F1 is the issuer's proxy circular. This is the same approach as is taken with respect to executive compensation disclosure, on the basis that the way in which the directors (or trustees) handle executive compensation and the grant of stock option and other incentives should be relevant information to unitholders in considering the re-election of the directors or trustees.

The constrains imposed by the *Income Tax Act* definition of mutual fund trust mean that it cannot be the trustees of an income trust in their capacity as such who will carry out the processes and functions for which are urged on all boards by the Governance Regulation. At its most extreme, one can say that there is a disconnect between the level of accountability sought to be achieved by the Governance Regulation (and indeed by the whole emphasis on the part of shareholders and others on governance) with the fact that those who are elected by the unitholders are, if they follow the requirements of the mutual fund trust definition, precluded from carrying out as part of the elected office the functions which they are supposed to be accountable.

Until recently, I would have regarded this "disconnect" as theoretical rather than real. In common with most other advisors, I would have relied on the thinking above concerning a more extended view of what is implicit in "investing funds in property", and the distinction between the different roles undertaken by the same individuals, as permitting the trustees to accept the responsibility for the governance of the subsidiary entity, without worrying that by so doing they might jeopardize the mutual fund trust status (which is of course absolutely pivotal from the point of view of the unitholders). Positions taken by CRA may however require some re-evaluation of that approach. In discussions with CRA concerning a ruling application for a structure in which the income trust would own all the limited partnership units of a partnership and all the shares of the general partner of the partnership, CRA indicated that for the ruling to be issued a majority of the directors of the general partner of the partnership would have to be persons other than trustees of the income trust. The reasoning appears to be as follows. A partnership (even a limited partnership) requires the partners to carry on business in common with a view to profit (to use the words of the *B.C. Partnership Act*). If the limited partnership units are owned directly or indirectly by an income trust, and if a majority of the board of directors of the general partner are trustees, that means by extension that the trustees (and hence the income trust itself) are engaged in carrying on the business, as opposed to merely investing in property. This ignores the fact that the general partner is a corporation, and would therefore (incorrectly) equate the directors with the corporation. If that is the reasoning, then the concern would not be restricted to trust over partnership structures, but could extend to trust over corporation structures.

There was a view that this issue is dealt with in section 253.1 of the *Income Tax Act*. That section provides that where a trust holds an interest as a member of a partnership and has the benefit of limited liability, then the trust is not, solely because of the holding of that interest, considered to carry on any business or activity of the partnership. I understand that CRA's response to that is that section 233.1 only deals with the passive ownership of a partnership interest, and does not address the circumstance where trustees of the trust form a majority of the board of directors of the general partner.

I imagine that many lawyers would find the line of reasoning laid out above (if indeed that is CRA's reasoning) to be puzzling and troublesome. We have generally been content, both from the perspective of compliance with the *Income Tax Act* requirements and maintenance of limited liability for the trust as a limited partner of the partnership, to differentiate between the roles of the individual as trustee and as director. Acceptance of the line of reasoning set out above would lead one to be concerned about the preservation of limited liability. I expect that upon reflection most practitioners would not change the views they have formed to date on this matter. Advisors should however recognize that CRA may take this position, and at a minimum advisors may wish to take this into account in any circumstance where a ruling or other confirmation is sought from CRA (always assuming that we reach a position that lifts the current moratorium on rulings relating to trust and other flow-through entities).

V. Governance Regulation

Policy 58-201 states that its guidelines ("Guidelines") are not intended to be prescriptive, and indeed instrument 58-101 does not require adherence to the Guidelines. (Copies of each document is attached.) The Guidelines do contain a lot of "shoulds", principally the following:

(i) the board should have a majority of independent directors,

(ii) the chair of the board should be an independent director,

(iii) the board should adopt a written mandate in which it explicitly acknowledges responsibility for the stewardship of the issuer,

(iv) the board should develop clear position descriptions for the chair of the Board, the chair of each board committee and the CEO,

(v) the board should ensure that directors receive a comprehensive orientation and continuing education,

(vi) the board should adopt the written code of business, conduct and ethics and be responsible for monitoring compliance with the code (to which is added the statement that conduct by a director or executive officer which constitutes a material departure from the code will likely constitute a "material change"),

(vii) the board should appoint a nominating committee and a compensation committee, each composed entirely of independent directors,

(viii) the board, each committee and each individual director should be regularly assessed regarding effectiveness and contribution.

Instrument 58-101 requires each proxy circular to include the disclosure required by Form 58-101F1 (the "Form"). The Form deals only with disclosure, so that in theory it is open to an issuer to say that it did not do some or all of the "shoulds" included in the Guidelines. It is fair to say however that the Form seems designed to paint issuers into something of a corner, because in many instances, while allowing the issuer to say that it does not comply with a particular Guideline, if the issuer says that it must then describe how it achieves the stated objective without following the Guideline. For example, if the board does not have a written board mandate, the circular must describe how the board delineates its role and responsibilities. Similarly, if there are no written position descriptions, then the circular must describe how the role and responsibilities of each position are delineated.

I suggest that two primary factors should influence the approach to governance of any particular income trust. These are first the sensible delineation of function between the trustees as such and the board of directors of the subsidiary entity as such (even if those are the same individuals). The second is the size of the board. It should be noted that neither of these focuses specifically on independence. In my experience, there is little difficulty in meeting the requirement that a majority of the board of trustees be independent (assuming, as appears to be the case, that being a director only of the subsidiary entity does not rob a trustee of independence).

The division of functions between trustees of the public income trust and directors of the operating entity where the trust fully controls the operating entity suggest that the following at least should be acknowledged to be responsibilities of the board of the subsidiary entity and not the board of trustees:

- the board mandate, and thereby for the stewardship of the business, including strategic planning, risk management, succession planning and internal control and management information systems;
- development of a position description for the CEO;
- any code of business conduct and ethics;
- compensation of management.

Other functions could remain with the board of trustees, particularly the nominating function and remuneration of trustees. However, it may be that so many of the functions should be handled by the board of directors of the subsidiary entity that it would be simpler for that body to undertake all of the functions which the issuer considers are appropriate to conform with the aspects of the Governance Regulation that are applicable to it.

Many income funds have a board of seven or less trustees, at least one usually being a member of management. Apart from the formal composition of its audit committee, all of the members of which must be independent, it may not be necessary from an efficiency point of view to handle compensation and nomination functions through a committee. It may well be that the board as a whole (other than management personnel) can handle these matters quite efficiently. The larger the board, the less efficient it becomes to have matters of that detail handled by the full board, in which event a committee structure makes more sense.

Some of the more specialized situations referred to above, such as the restaurant royalty trusts or the circumstances in which control of the management of the operating business rests with third parties, may require a different approach. That approach must balance the desire of the private entity which controls the operating entity not to accept the responsibility it would have if it were in direct control of a public entity, with the recognition that it is unrealistic to expect the trustees of the public entity to discharge all of the functions contemplated by the Governance Regulation when they do not control the operating entity. As mentioned above, the introduction of variable interest entity accounting creates some unique issues in relation to responsibility for internal controls and the integrity of the financial statements when the trustees of the public entity do not in fact control the underlying entity. It will be up to issuers and their advisors to develop mechanisms that provide as much comfort as possible that the public board will not be made responsible for things it cannot control, while not exposing the officers and directors of the private entity to an undue level of responsibility.

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