Canadian Income Trusts: New Tax Rules, New Exposures and D&O Insurance Concerns

By Garth Pepper and Andrew Brown

Canada's Income Trust Market has grown exponentially as the sector recently attained mainstream credibility in Canadian capital markets. Today many of Canada's leading companies have chosen the trust structure as their means of realizing value for unit-holders.

Accompanying this upswing in the trust sector are increased concerns regarding the responsibilities and potential liabilities of trustees, directors and officers of income trusts. These liabilities have been further impacted by the October 31, 2006 announcement that the Government of Canada intends to impose a new tax regime on publicly listed flow-through entities, news that surprised many in the investing public.

While many trusts have purchased Directors and Officers (D&O) liability insurance to protect trustees and executives, given the nuances of D&O insurance and the potential complexity of an income trust model, no "one size fits all" approach can be said to be the most appropriate insurance strategy. Absent a careful risk analysis and a customized approach, income trusts and their executives may face serious unprotected liabilities.

As a highly customized insurance contract, a trust's D&O policy needs to be diligently structured at the time of conversion to identify and resolve potential deficiencies in coverage that may exist. Originally written for corporations, not trusts, traditional D&O policies often require extensive modification in order to respond properly for trust exposures. Several important D&O insurance issues need to be addressed when converting from a traditional corporate structure (private or public) to an income trust, including:

- Liabilities associated with the predecessor company may be left uncovered by the trust's policy, including those associated with information provided to investors in the new trust about historical financial performance.

- Representations made to investors in the trust's "road-show" presentation can be problematic, in terms of D&O policy interpretation, and need to be carefully crafted into the trust's D&O insurance contract.

While the full impact of the government's new tax rules on the liability of trustees and other stakeholders of publicly listed trusts is yet to be determined, undoubtedly the rules have a wide array of D&O implications. Along with the initial immediate de-valuation of many trusts, the tax rules

may initiate new trends that will influence the D&O exposure of those managing income trusts. For example:

- Some income trusts may convert back to a corporate structure.
- Other trusts may consider converting to an Income Deposit Securities/Income Participating Securities structure in order to try and maintain their distributions in a tax-efficient manner.
- M&A activity may increase as undervalued trusts become takeover targets.
- Conflicts could increase between management with a retained interest at the trust and operating company levels, and the interests of unit-holders.
- Determining proper accounting practices for income tax deductions and for disclosing these practices to investors may be difficult.
- Inherent conflicts of interest between a trustee's duty to unit-holders and an officer's duty to the operating company could arise especially for those who serve as both a trustee and an officer.

These and other income trust issues can further complicate the already complex realm of executive protection. We strongly encourage you to review the efficacy of your D&O program in the context of how it will respond to the continually changing nature of your risks.

Garth Pepper is a Senior Associate and the National Management Risk Practice Leader for Integro (Canada) Ltd., based in Toronto; he may be reached at:
garth.pepper@integrogroup.com.

Andrew Brown is an Associate in the Management Risk Practice of Integro (Canada) Ltd.; he may be reached at:
andrew.brown@integrogroup.com.

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