

**Second Submission on  
Ontario ULC Legislation**

***Business Corporations  
Act (Ontario)***

**CORPORATE LAW SUBCOMMITTEE,  
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## **SECOND SUBMISSION ON ONTARIO ULC LEGISLATION**

The purpose of this submission is two-fold. First, it argues that Ontario should, change the *Business Corporations Act*<sup>1</sup> so that direct inbound foreign investment can be channelled through an Ontario unlimited corporation.<sup>2</sup> Second, this submission discusses the modest changes that would be required to the *OBCA* to accomplish this purpose.

### **I. EXECUTIVE SUMMARY**

- The flow-through treatment of unlimited companies has proven extremely attractive for direct inbound investment from U.S. investors.
- There is no loss of Canadian tax revenue from allowing ULCs to be used as vehicles for direct foreign investment into Canada.
- An Ontario ULC would offer a number of advantages for foreign investors in comparison to the Nova Scotia ULC, particularly in removing an additional layer of complexity and expense.
- An avoidable layer of complexity and expense should not be considered an acceptable cost of doing business in Canada.
- Ontario, as the financial engine of the country, should signal that it welcomes foreign investment and strives to create an efficient corporate regime to facilitate it.
- Adopting ULC legislation should form an integral part of the drive to keep Ontario's commercial laws competitive by global standards.

### **II. BACKGROUND**

#### **1. Why the ULC is Attractive to Direct Inbound U.S. Investment**

Like the *Income Tax Act*,<sup>3</sup> the U.S. *Internal Revenue Code*<sup>4</sup> treats partnerships and branches as flow-through vehicles for tax purposes. This means that income, though calculated at the partnership level, is taxed in the hands of the partners or owners regardless of whether the profits are paid out by the partnership or branch. On the other hand, if the entity were treated as a corporation, then under the U.S. Code, it would, as in Canada, be taxed as a separate taxpayer. The U.S. tax treatment of corporations and partnerships is consistent with the treatment of these

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<sup>1</sup> R.S.O. 1990, c. B.16 [hereinafter the "OBCA"].

<sup>2</sup> An unlimited corporation under the OBCA or an unlimited company under the *Corporations Act*, R.S.N.S. 1989, c. 81 [hereinafter the "NSCA"] are sometimes hereinafter interchangeably referred to as a "ULC".

<sup>3</sup> R.S.C. 1989, c. 1 (5<sup>th</sup> Supplement) [hereinafter the "ITA"].

<sup>4</sup> The U.S. Internal Revenue Code is hereinafter referred to as the "U.S. Code".

entities for commercial law purposes. Corporations are treated in law as distinct legal entities whereas, at common law, partnerships are treated as relationships, not legal entities.<sup>5</sup>

Income flowing through a corporation is generally subject to the imposition of two levels of tax: once at the corporate level; and a second at the shareholder level. Under the U.S. Code, there is less than perfect integration of income flowed through a corporation unless an S-corp is used.<sup>6</sup> Otherwise stated, the U.S. Code levies an element of double taxation unless a flow-through vehicle is used.

Prior to January 1, 1997, the U.S. Internal Revenue Service<sup>7</sup> applied various tests to determine whether an entity would be treated for the purposes of the U.S. Code as a corporation or a non-corporate entity (a partnership or branch operation). Under the pre-1997 rules, the determination of whether an entity was to be treated under the US Code as a flow-through entity or as a corporation turned on the application of four discrete factors. These are depicted in Table 1 below.

**TABLE 1**

**Pre-1997 Factors For Classifying Entities as a Partnership or Branch or as a Corporation**

| <b>Factor</b>                | <b>Partnership or Branch</b>    | <b>Corporation</b>   |
|------------------------------|---------------------------------|----------------------|
| Limited liability            | Unlimited liability for members | Limited liability    |
| Transferability of interests | Restricted transferability      | Free transferability |
| Management centralization    | Decentralized                   | Centralized          |
| Duration                     | Limited continuity              | Perpetual            |

The IRS applied these tests to the determination of whether an entity was a partnership or “disregarded entity” or a corporation. If the entity failed two or more of the four

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<sup>5</sup> Except in Scotland and as otherwise expressly provided by specific statute.

<sup>6</sup> An S-corp derives its name from the subchapter of the U.S. Code that provides for its tax treatment.

<sup>7</sup> The U.S. Internal Revenue Service is hereinafter referred to as the "IRS".

indicia of a corporation set forth above, the IRS treated it as a partnership or branch depending on whether it had one or multiple members.

Effective January 1, 1997, the IRS promulgated and brought into force the *Simplification of Entity Classification Rules*, commonly known as the "check-the-box" regulations.<sup>8</sup> The new Regulations abandoned the application of the four indicia of corporate status referred to above. In their place, the Regulations allowed a "qualified entity" to file a prescribed form electing how it wished to be treated for U.S. tax purposes: (a) as a corporation; or (b) for "disregarded treatment" (as a partnership, if it has two or more members, or as a branch, if it has only one member). The main focus of the change was to simplify life for the U.S. limited liability company,<sup>9</sup> a true hybrid that has some of the attributes of a corporation and some of the attributes of a partnership or proprietorship. The LLC has no counterpart in Canadian law. The LLC was a relatively new phenomenon in the U.S., the first LLC statute having only been passed in Wyoming in 1977. However, once the flow-through tax treatment of the LLC under the U.S. Code was accepted, the LLC form of vehicle took flight and, particularly in the early 1990s onwards, was made available in other U.S. states.<sup>10</sup>

Consistent with the treatment accorded the LLC, the Regulations permit any Canadian "corporation or company formed under any federal or provincial law which provides that liability of all of the members of such corporation or company will be unlimited" to qualify as a partnership or a "disregarded entity" regardless of what other corporate characteristics it may have.<sup>11</sup>

Currently, only an unlimited company formed under the Nova Scotia *Companies Act*<sup>12</sup> is eligible to elect "disregarded entity" treatment under the U.S. Code. Nova Scotia has a monopoly on the formation of ULCs in Canada.<sup>13</sup>

Recognizing its monopolistic position, effective April 1, 2002, the Government of Nova Scotia announced in its budget speech that it would raise the filing fees payable by an unlimited company to the Registrar of Joint Stock Companies. At that time, the fee for incorporation of an NSULC went from \$335 to \$3,000 (an increase of 895%) and the fee for annual returns for an NSULC went from \$85 to \$1,000 per year (an increase of 1,176%). The annual fee doubles if paid late. However, the Government of Nova Scotia decided, in April 2004, there was more than one way to double its tax revenues. Thus, effective April 1, 2004, the Government of Nova Scotia increased these fees, again, from \$3,000 to \$4,000 for incorporation of an NSULC and from \$1,000 to \$2,000 in annual fees for an NSULC. There were no fee increases for companies limited by shares, the type of company that would be used by purely

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<sup>8</sup> The *Simplification of Entity Classification Rules* are hereinafter referred to as the "Regulations".

<sup>9</sup> The limited liability company is hereinafter referred to as an "LLC".

<sup>10</sup> Florida was the only other state to enact LLC laws before 1989. The explosion in LLC state laws came in the early 1990s.

<sup>11</sup> Regulations, para. 7(b)(8)(ii)(b).

<sup>12</sup> NSCA, *supra*, note 2.

<sup>13</sup> An unlimited company formed under the NSCA is hereinafter referred to as a "NSULC".

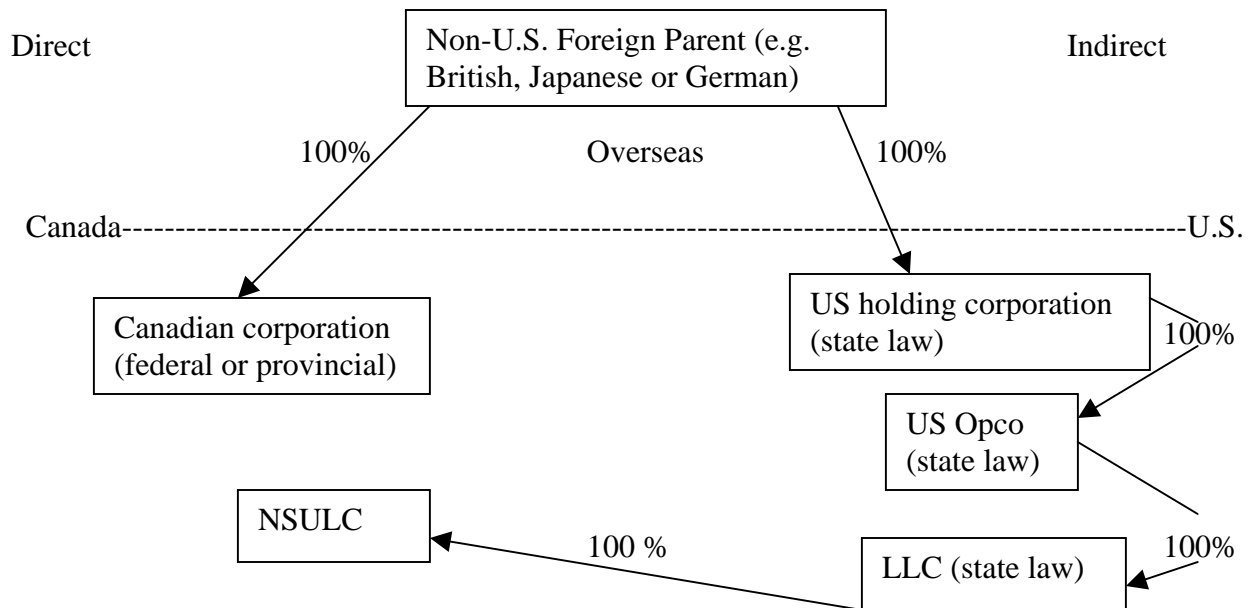
domestic or local businesses. In light of the tests set out in the Supreme Court of Canada decision in *Re Eurig Estate*,<sup>14</sup> these fees probably represent a disguised direct tax on the NSULC. In recognition of this, the Government of Nova Scotia now describes these fees as a tax.

## 2. Some Practical Uses that Foreign Investors Have Made of Unlimited Companies

The flow-through treatment of the NSULC has proved extremely attractive for direct inbound investment from U.S. investors and from non-U.S. foreign investors who invest in Canada *via* the U.S. For example, a German, U.K. or Japanese investor can either invest directly into Canada from its home jurisdiction (in which case the ULC is not a viable option) or can invest into the U.S. and have its U.S. subsidiary make the direct investment in Canada (in which case the NSULC becomes an option). These alternative investment structures are depicted in Figure 2 below.

**Figure 2**

### **Alternative Structures for Non-U.S. Investment into Canada**



**Notes:**

1. In the direct non-U.S. investment, there is no advantage, but some disadvantage, to use of an NSULC (e.g. unlimited liability and costs).
2. In indirect non-U.S. investment, the above structure facilitates: (a) flow-through U.S. tax treatment of the NSULC; (b) limited liability shield for U.S. Opco; and (c) consolidation of financial reporting.

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<sup>14</sup> [1998] 2 S.C.R. 569, where a majority of the Court held that a probate fee was a direct tax because it was compulsory, charged by a public body and intended for a public purpose. The lack of a nexus between the fee charged and the cost of the service was also considered.

3. In the above example, the LLC could elect to be taxed as a corporation or as a “disregarded entity”. U.S. tax and tax treaty issues will determine LLC’s election.
4. The LLC traps the NSULC’s unlimited liability at the LLC level, protecting the assets of US Opco.

During the past decade or so, U.S. tax practitioners have found several practical uses for the NSULC which have made it by far the vehicle of choice for large-dollar direct investment from the U.S. into Canada. Although not exhaustive nor necessarily current, examples of U.S. tax advantages in using the NSULC to date include the following:<sup>15</sup>

- (a) Losses realized by the NSULC may be applied against the profits of the U.S. shareholder; otherwise, losses sustained by a Canadian subsidiary corporation are not deductible against U.S. taxable income.
- (b) If a U.S. purchaser acquires all the shares of an NSULC from a Canadian vendor, the Canadian vendor will be taxed under the ITA on the basis of a sale of shares whereas the U.S. purchaser will be taxed under the U.S. Code on the basis that it has acquired assets. A share sale may be attractive to the Canadian vendor so that he or she may first access the \$500,000 lifetime capital gains exemption or the 50% inclusion rate for capital gains not qualifying for the exemption. Under U.S. tax law, the result could be, for example, a step-up in the basis (in U.S. tax parlance) of the underlying assets, allowing the U.S. investor to enjoy larger tax depreciation deductions than would otherwise have been available. If the Canadian target company is not an NSULC, it is possible to export the target company to Nova Scotia and have it amalgamated so that the amalgamated company becomes an NSULC. In take-overs of Canadian companies, the NSULC effectively allows the Canadian vendor and the foreign purchaser some of the best of both the Canadian and U.S. tax worlds.
- (c) The U.S. Code limits the availability of foreign tax credits where a foreign subsidiary is a certain number of tiers (or layers) below the U.S. corporation in the organization chart. Since it is disregarded, use of the NSULC eliminates one tier from the analysis and, therefore, moves the U.S. corporation one step closer to the foreign tax credit.
- (d) Unlike U.S. corporations, U.S. individuals can generally not claim the underlying Canadian income tax paid by a Canadian corporation as a foreign tax credit. An NSULC can be used to enable the U.S. individual (usually *via* an S corporation) to claim the underlying income tax as a foreign tax credit.
- (e) An NSULC can be used to defer (until the after-tax income is paid to the U.S. parent as a dividend)<sup>16</sup> non-resident withholding taxes that would otherwise be exigible on lease payments to a non-resident lessor. If an NSULC is used as the

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<sup>15</sup> The discussion of U.S. tax treatment is illustrative only. Readers are cautioned to obtain qualified U.S. tax advice in every case. McMillan Binch LLP does not purport to provide U.S. tax advice.

<sup>16</sup> If the NSULC pays a dividend to its U.S. parent, Canadian withholding taxes apply.

lessor, no Canadian withholding tax applies. The ITA treats the NSULC as a Canadian corporation and the payment from lessee to lessor as purely domestic. At the same time, the NSULC is disregarded for purposes of the U.S. Code. Under the U.S. Code, the U.S. shareholder of the NSULC receives the same tax treatment it would have obtained had the lessor been a U.S. taxpayer. The NSULC, therefore, opens the door for inbound leases from the U.S. and provides Canadian lessees with access to the U.S. leasing market. The result is lower lease rates for Canadian lessees able to conclude cross-border leasing transactions that take advantage of U.S. tax benefits available to lessors of certain types of equipment.

- (f) If a Canadian resident wishes to emigrate to the U.S., double taxation can result. In most cases, the ITA imposes a so-called departure tax on the emigrant. The departure tax includes the capital gain that results from the deemed disposition of the emigrant's property and its deemed reacquisition at fair market value.<sup>17</sup> Thus, a Canadian taxpayer pays tax as if he or she had sold the property at FMV even though there is no sale and, therefore, no actual proceeds of disposition with which to pay tax. Later, when the taxpayer, who is now a U.S. resident, disposes of the same assets, the U.S. Code will treat the basis of the assets to be their initial adjusted cost base<sup>18</sup> rather than the FMV at the time of departure. In effect, the IRS will ignore the Canadian tax paid on the difference between FMV at the time of departure and the ACB. This unfavourable result can be avoided by having the Canadian resident transfer his or her assets by way of tax-deferred rollover into an NSULC. The U.S. Code allows the taxpayer to treat the assets as having a basis equal to FMV on the deemed disposition, thus minimizing future U.S. capital gains tax.
- (g) The U.S. Code will disregard for tax purposes a spin-off of an NSULC to the shareholders of a Canadian corporation by way of dividend *in specie*.

The NSULC thus has the unique advantage of constituting a corporation for Canadian tax purposes while, at the same time, being eligible for treatment as a partnership or branch for U.S. tax purposes. It is this difference in characterization under Canadian and U.S. tax law (or tax law arbitrage) that has proven to be extremely useful. The key point is that creative U.S. tax counsel will continue to find practical uses for the ULC. The foregoing are only examples of some applications that have been used to date.

### 3. Absence of Any Canadian Tax Disadvantage to Allowing Foreign Investment Through a ULC

An NSULC is a “company” under the NSCA.<sup>19</sup> Regardless of what treatment the NSULC may receive under the U.S. Code, it is still treated as a “Canadian corporation” under

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<sup>17</sup> Fair market value is hereinafter referred to as "FMV".

<sup>18</sup> Adjusted cost base is hereinafter referred to as "ACB".

<sup>19</sup> NSCA, s. 2(1)(c).

the ITA. Thus, there is no difference whatsoever between the Canadian tax treatment of the NSULC and the Canadian tax treatment of a corporation under the OBCA or the *Canada Business Corporations Act*<sup>20</sup>, or a company limited by shares under the NSCA. The tax advantages to the NSULC are all U.S. tax advantages. Thus, there is no loss of Canadian tax revenue from the continuance and perpetuation of the ULC as a vehicle for direct foreign investment into Canada.

#### 4. Nova Scotia as the Only Jurisdiction in Canada that Allows Formation of a ULC

The concepts of "company limited by shares", "company limited by guarantee" and "unlimited company" originated in the English *Companies Act*. Like a number of other jurisdictions in Canada, Nova Scotia modelled its early corporate law on the English statute.<sup>21</sup> Other jurisdictions in Canada, such as Alberta (until 1981) and British Columbia (until March 29, 2004) also followed the U.K. statute as their model but did not permit, or eliminated the possibility of, forming unlimited companies, which were correctly seen to be commercially unattractive.

Unlike a number of other jurisdictions in Canada (namely, the federal jurisdiction, Ontario, British Columbia, Alberta, Saskatchewan, Manitoba, New Brunswick, Newfoundland and Labrador, Yukon, Nunavut and the Northwest Territories), Nova Scotia has never implemented a wholesale reform of its corporate legislation. Thus, the possibility of creating an NSULC was never been removed from the NSCA.

Until recently, use of the NSULC remained largely dormant. However, in the past dozen years or so, the enormous potential U.S. tax advantages of the NSULC have led to its emergence as the preferred vehicle for large-dollar direct U.S. investment into Canada. What was once considered an inconspicuous weed has quickly grown into a mighty oak.

#### 5. To What Extent the NSULC is Being Used

As of May 9, 2002, there were 2,430 registered unlimited companies in Nova Scotia. A further 250 have been de-registered. Comparatively, the volume of NSULC use is insignificant. For instance, in the fiscal period ending March 31, 2002, a total of 48,919 companies were incorporated under the OBCA. In the same time frame, 647 unlimited companies were incorporated under the NSCA. Thus, the incorporation of NSULCs represents about 1% of the annual volume of incorporations under the OBCA.<sup>22</sup> However, like the oak, the significance of the NSCLU is not to be assessed by sheer number.

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<sup>20</sup> R.S.C. 1985, c. C-44, as amended [hereinafter, the "CBCA"].

<sup>21</sup> The *UK Companies Act*, 1862 was a consolidation of several statutes and, as noted by Sir Francis Palmer, is "The *Magna Carta* of co-operative enterprise" as quoted in G. Morse et al., eds. *Palmer's Company Law*, 25<sup>th</sup> ed., Vol. 1 (London: Sweet & Maxwell, 1992) at para. 1.110.

<sup>22</sup> Even if all of the NSULCs had been incorporated in the five years since the Regulations went into effect, the mean rate would be less than 500 per year.

Although no statistical data is available, there is widespread recognition that, however small the volume of NSULCs, their significance is great. Many of the largest and most significant investments in Canada in the past 5-12 years have been made through the NSULC. The larger the dollar-value of the transaction, the more the incremental tax savings can make up for the relatively fixed additional costs of using an NSULC. The widespread consensus among many leading Ontario corporate lawyers is that U.S. and other foreign investors are compelled to establish and operate NSULCs for purely jurisdiction-shopping reasons. Never is there a compelling non-tax reason for the use of a NSULC. If the investors want the favourable U.S. tax treatment, there simply is no other choice.

### III. ARGUMENTS AND ISSUES

#### 1. Apart from the Favourable US Tax Treatment, Foreign Investors are Not Otherwise Well-Served by Being Forced to Use the Nova Scotia Statute

Aside from the NSULC, the NSCA has two other features that can be attractive to foreign investors. First, there is no requirement under the NSCA for any Canadian resident directors on the board or on any committee of the board.<sup>23</sup> Thus, there is no need for foreign investors to find any Canadian directors. Directors can be selected for their personal merit, not to satisfy statutory compliance concerns. Second, unlike under the CBCA and the corporate laws of all provinces and territories other than British Columbia, the NSCA does not contain any statutory restriction precluding a subsidiary from holding shares in its parent.<sup>24</sup> Nor does the NSCA expressly prohibit a direct or indirect subsidiary from owning shares in an NSULC. In certain exchangeable share transactions and other take-overs, it is often important that the subsidiary hold shares in its parent. These perceived advantages are applicable to all companies formed under the NSCA. They are not unique to the NSULC.

The first of these perceived advantages is not unique to Nova Scotia. The corporate statutes in all three territories and all provinces other than Ontario, Alberta, Saskatchewan, Manitoba and Newfoundland and Labrador permit the corporation to dispense with any resident Canadian directors.<sup>25</sup> Indeed, the incorporation statutes in New Brunswick and the Yukon Territory are probably more frequently used for this purpose than the NSCA. The New Brunswick and Yukon statutes have the advantage of modernity, closely following the CBCA model (prior to its recent reform in November, 2001). The CBCA, which has served as the model for the OBCA and many other provincial and territorial statutes, is, in turn, modelled on certain U.S. statutes including, in particular, those of New York and Delaware and the *Model*

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<sup>23</sup> See W.D. Gray: "Shopping for that Perfect ... Corporate Statute" in *Return of the Six-Minute Business Lawyer* (Toronto: Law Society of Upper Canada, Department of Continuing Legal Education, 2000) [hereinafter, "Jurisdiction Shopping"].

<sup>24</sup> CBCA, s. 30(1). Recently, the CBCA and its regulations were changed to permit a limited exception where a subsidiary of a distributing corporation is used to complete certain cross-border share-for-share acquisitions. See CBCA, s. 31(3), (4), (5) and (6) and the *Canada Business Corporations Regulations*, Part 3 (Corporate Interrelationships), ss. 35-8.

<sup>25</sup> Jurisdiction Shopping, *supra* note 23, at 2-20. In its new *Business Corporations Act*, S.B.C. 2002, c.57 [hereinafter, the "BCBCA"] British Columbia did not include the former provisions of its *Company Act*, R.S.B.C. 1996, c.62 (hereafter, the "BCCA") requiring a majority of resident Canadian directors and at least one British Columbia resident director.

*Business Corporations Act*.<sup>26</sup> The CBCA and the OBCA thus use terminology and concepts familiar to U.S. investors and their counsel. As a pure corporate statute, the OBCA is a much better fit for U.S. investors than the NSCA. Also, the unanimous shareholder declaration and the unanimous shareholder agreement permit all board powers and liabilities to be transferred from the board of an OBCA corporation to its shareholders. Thus, a foreign investor can achieve under the OBCA the functional equivalent of a board without any Canadian resident representation.

British Columbia also permits incestuous share purchase transactions that are either upstream (where the B.C. corporation acquires shares in its parent or other upper-tier holding company) or downstream (where a subsidiary or other lower-tier subsidiary of the B.C. corporation acquires shares in the B.C. corporation).<sup>27</sup> As a pure corporate statute, the BCBCA<sup>28</sup> is superior to the NSCA. The British Columbia statute was introduced in March 2004 and is the newest Canadian corporate statute. The NSCA has never undergone thorough reform.

The NSCA presents several disadvantages for foreign investors:

- (a) As a general observation, the NSCA is an idiosyncratic statute, little of which is modelled on the CBCA. It is not one with which U.S. investors and their counsel would generally be familiar.
- (b) Much of the NSCA looks archaic;<sup>29</sup> and its subject matters, language and organization often appear obscure at least to the uninitiated.<sup>30</sup>
- (c) Conversion of a corporation formed under the laws of another Canadian jurisdiction into a NSULC is not straightforward. A corporation formed under the laws of another Canadian jurisdiction can only be imported into Nova Scotia as a company limited by shares. A second company must exist or be incorporated under the NSCA – generally as a “company limited by shares” to save the stiff incorporation tax for an NSULC. The imported company limited by shares can then be amalgamated with the existing or new NSULC to form an amalgamated company that may be either a NSULC or a company limited by shares. Apart from the added expense and complexity entailed in converting a corporation formed elsewhere into a NSULC, the amalgamation triggers a year-end for each amalgamating company for purposes of the ITA. Unless timed to coincide with a financial year-end, the amalgamation will require the preparation of extra sets of

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<sup>26</sup> R.W.V. Dickerson, L. Getz and J.C. Howard, *Proposals for a New Business Corporations Law for Canada: Commentary and Draft Act*, Vol. 1 (Ottawa: Information Canada, 1971) [hereinafter, the “Dickerson Report”].

<sup>27</sup> Jurisdiction Shopping, *supra* note 23 at 2-12.

<sup>28</sup> BCBCA, *supra*, note 25.

<sup>29</sup> Examples of archaic sets of provisions are those concerning par value shares, the liability of contributories and the use of the memorandum of association as the method of incorporation.

<sup>30</sup> For example, s. 26(17) of the NSCA sets out confusing rules for calculating paid-up capital and s. 51(1) which specifies changes that may be made to the memorandum of association without stating whether these amendments are exhaustive or merely inclusive.

financial statements and may, for example, accelerate the expiration of non-capital loss carryforwards.<sup>31</sup>

- (d) The unanimous shareholder agreement, which is the primary tool for the private ordering of closely-held or non-offering corporations under the OBCA and the CBCA, has no statutory recognition in the NSCA.<sup>32</sup>
- (e) Any limitations on the authority of the board of a NSULC must be set out in publicly filed articles of association.<sup>33</sup> Shareholders and management are typically reluctant to disclose such matters in the public record.
- (f) It is difficult to do leveraged-buyout transactions<sup>34</sup> under the NSCA because there is no exemption for share purchase financial assistance provided by a wholly-owned subsidiary in favour of its parent. Nor is there a safe harbour provision for good faith lenders.<sup>35</sup> The CBCA has abolished the prohibition against share purchase financial assistance.<sup>36</sup> The OBCA contains an exemption where a wholly-owned subsidiary provides upstream financial assistance to its parent.<sup>37</sup>
- (g) Court orders are required to approve amalgamations, adding to the expense, for example, of converting a corporation formed under the laws of another jurisdiction into an NSULC.<sup>38</sup>
- (h) In the absence of unanimous approval, a special resolution under the NSCA requires approval at two separate shareholder meetings held not less than 14 days apart, a process that is expensive, time-consuming and cumbersome for public companies and private companies having large numbers of shareholders.<sup>39</sup> A special resolution is required, for example, to approve an amalgamation, an export continuance or an alteration of the share provisions set out in the memorandum and articles of association of a NSULC. However, the NSLC rarely has more than a few shareholders.

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<sup>31</sup> Note, however, that in an *ex parte* unreported decision made on September 2, 2004, Moir J. held, in *Re: E.L. Management Incorporated* 2004 NSSC 169, that the arrangement provisions of the NSCA could also be used to convert a company limited by shares into an unlimited company. While use of the arrangement provision still requires a court order, it avoids triggering an additional year end for tax purposes. Arrangements will doubtless become the preferred method of converting a NSCA company limited by shares into an NSULC otherwise than at fiscal year-ends.

<sup>32</sup> OBCA, s. 108(2)-(6); CBCA, s. 146. See also *Jurisdiction Shopping*, *supra* note 23 at 2-2.

<sup>33</sup> NSCA, Sch. 1, Table A, s. 147.

<sup>34</sup> The leveraged-buyout transaction is hereinafter referred to as an “LBO”.

<sup>35</sup> *Jurisdiction Shopping*, *supra* note 23 at 2-2.

<sup>36</sup> Bill S-11.

<sup>37</sup> OBCA, s. 20(3)(c). Even if the upstream exemption does not apply, s. 20(2) of the OBCA only requires that the OBCA corporation provide post-transaction notice of the financial assistance to its shareholders.

<sup>38</sup> NSCA, s. 134(5).

<sup>39</sup> NSCA, s. 87(1) and (2).

- (i) Arrangements, reorganizations and minority squeeze-out procedures under the NSCA are much less explicit than the arrangement provisions of the CBCA and the OBCA.<sup>40</sup>
- (j) The conditions attached to preferred shares must be set out *verbatim* in the share certificates representing these shares.<sup>41</sup> It is not enough to incorporate these share conditions by reference.
- (k) There are no rules to protect *bona fide* transferees of shares in a NSULC for value without notice from adverse claims.<sup>42</sup> The NSCA is, therefore, out of step with the prevailing North American security transfer regime, currently the best Canadian example of which may be found in Part VI of the OBCA.
- (l) Unlimited liability is determined on the winding-up of the NSULC.<sup>43</sup> However, the NSCA does not define what constitutes a “winding-up” for purposes of triggering shareholder liability, thus creating ambiguity and uncertainty in a matter of critical concern to investors. Members investing in an NSULC should generally proceed on the footing that unlimited liability will crystallize on the liquidation or bankruptcy of the NSULC.
- (m) To be registered under the Nova Scotia *Corporations Registration Act*<sup>44</sup> and to maintain its registration, a company incorporated under the NSCA must have a “recognized agent” resident in Nova Scotia,<sup>45</sup> file an annual statement of agent<sup>46</sup> and pay an annual fee.<sup>47</sup>
- (n) Companies incorporated under the NSCA are required to have a registered office in Nova Scotia.<sup>48</sup> The registered office is frequently located at the office of the lawyer who has been involved in the incorporation of the company.
- (o) At \$4,000, the incorporation tax for an NSULC under the NSCA is by far the highest in Canada.<sup>49</sup> It is more than 13 times the incorporation fee under the OBCA (\$300 if filed electronically) and 20 times the equivalent fee under the CBCA (\$200 if filed electronically).

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<sup>40</sup> Jurisdiction Shopping, *supra* note 23 at 2-2.

<sup>41</sup> NSCA, s. 50(4).

<sup>42</sup> Jurisdiction Shopping, *supra* note 23 at 2-2.

<sup>43</sup> NSCA, s. 135.

<sup>44</sup> *Corporations Registration Act*, R.S.N.S. 1989, c. 101.

<sup>45</sup> CRA s. 9.

<sup>46</sup> CRA s. 10

<sup>47</sup> CRA s. 12

<sup>48</sup> NSCA s. 29

<sup>49</sup> As of April 1, 2004, the tax for forming an NSULC on incorporation or amalgamation increased from \$3,000 to \$4,000.

- (p) At \$2,000, the annual tax for filing an annual statement for an NSULC under the NSCA is 100 times more than the fee charged for an electronic filing of an annual return under the CBCA (\$20). No fees are charged for filing an annual return under the *Corporations Information Act* (Ontario).<sup>50</sup>

The conclusion that must be drawn, therefore, is that the tax advantages in using the NSULC override the numerous technical deficiencies and incremental costs of the NSCA. These tax advantages are also what has prompted the Nova Scotia Government to capitalize on its prevailing monopoly on the formation of ULCs in Canada.

## 2. Industry Canada is Not Prepared to Consider a Federal ULC Regime until 2006

In November, 2001, Industry Canada finally completed its Phase II reform of the CBCA which consummated more than seven years of work.<sup>51</sup> Industry Canada is not scheduled to consider further amendments to the CBCA until 2006. In the meantime, Industry Canada has turned its attention to the proposed *Not-For-Profit Corporations Act*.

Industry Canada has confirmed that it has no appetite for implementing a federal ULC regime before 2006.<sup>52</sup> A federal regime would have the distinct advantage of being available to foreign investors wherever in Canada they choose to operate. All corporate lawyers in Canada are qualified to incorporate, advise on and give opinions in relation to federal corporations. However, 2006 is too long to wait for federal action. Nor is there any assurance that a federal ULC regime will ever materialize.

There is probably an insufficient volume of potential ULC incorporations to justify having every province and territory introduce its own statute. The heaviest users of the ULC are based in Ontario. Outside Ontario, there would be diminishing returns from a proliferation of provincial and territorial ULC legislation. Ontario legislation is likely to preempt the need for any further legislation in Canada whether federal, provincial or territorial.

## 3. If Ontario Allowed the Formation of ULCs, there would be Compelling Reasons Why U.S. Investors Would Favour the Ontario ULC

Compared to an NSULC, an Ontario ULC would offer the following advantages for a U.S. investor:

- (a) It would simplify the operational affairs of the Canadian subsidiary. For instance, often, a Canadian holding company will be formed as an NSULC. However, the place of operations of the primary operating company may be in a different

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<sup>50</sup> R.S.O. 1990, c. C-39.

<sup>51</sup> R.C. 2001, c. 14 (formerly, Bill S-11, entitled "*An Act to Amend the Canada Business Corporations Act and the Canada Cooperatives Act and to Amend Other Acts in Consequence*" was proclaimed into force on November 24, 2001 (S1/2001-114)).

<sup>52</sup> Discussion between Mr. Wayne D. Gray of the Corporate Law Subcommittee of the Business Law Section of the Ontario Bar Association [hereinafter, the "OBA"] and Ms. Veronica Wessels, Counsel at Industry Canada, Policy Branch, held on April 5, 2002.

Canadian jurisdiction and its incorporation may be under a different Canadian statute (for example, the CBCA or the OBCA). The take-over, financing or reorganization that prompted the use of the ULC would rarely be run from Nova Scotia. Aside from the NSULC, the U.S. investor may have no other reason to be conducting business in Nova Scotia.

- (b) The necessity of having a NSULC almost inevitably forces the parties to double the number of sets of lawyers used in transactions such as acquisitions, divestitures, corporate reorganizations, share offerings and debt offerings. Nova Scotia counsel must be involved if a NSULC is involved in the transaction. Only Nova Scotia counsel can advise a NSULC on corporate law matters and prepare or approve corporate documents involving the NSULC. Typically, third party legal opinions are required on these transactions. If a NSULC is involved, an Ontario lawyer cannot opine on its existence, corporate capacity and due authorization. Thus, various aspects of the transaction must be allocated between the various jurisdictions involved. Since Ontario is the financial centre of the country and the NSULC is often used in large-dollar transactions, a typical transaction would see each side retain counsel in Ontario and Nova Scotia. The role of Nova Scotia counsel is typically confined to the corporate law and opinion matters involving the NSULC. The rest of the transaction is handled entirely in Ontario. Two sets of lawyers are needed where otherwise one set would suffice. The cumbersome legal structure imposes unnecessary cost, inconvenience and delay on the foreign investor. Additional complexity and layers of lawyers add significantly to overall transaction costs.
- (c) In contrast to the NSCA, the OBCA is a modern, almost state of the art, corporate statute. It uses concepts and terminology already familiar to U.S. investors and their advisors as the OBCA in an indirect derivative of U.S. corporate statutes.<sup>53</sup>
- (d) The OBCA protects the wages of all employees wherever located.<sup>54</sup> The OBCA imposes personal liability on the directors for the entire payroll of the OBCA corporation, including vacation pay. The NSCA does not protect the wages of employees. Indeed, no employment standards or other statute in Nova Scotia protects the wages of employees, even the wages of Nova Scotia resident employees.<sup>55</sup> Ironically, therefore, formation under the OBCA would better protect the wages of Nova Scotia and other Atlantic Canadian workers than formation under the NSCA.<sup>56</sup>

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<sup>53</sup> See note 26.

<sup>54</sup> OBCA, s. 131.

<sup>55</sup> Jurisdiction Shopping, *supra* note 23 at 2-2.

<sup>56</sup> See, for example, *Proulx v. Sahalien Goldfields Inc.* (2001) 55 O.R. (3d) 775 (C.A.) where it was held that the OBCA protected the claims of employees working in West Africa.

- (e) The OBCA has also reformed its financial assistance provisions so that they no longer pose a significant impediment to share purchase or other financial assistance transactions. The OBCA financial assistance provisions contain an express exemption for the LBO.<sup>57</sup>
- (f) Some corporate procedures are much simpler under the OBCA than under the NSCA. Examples include amalgamations, shareholder meetings, arrangements, reorganizations and minority squeeze-outs.
- (g) Part VI of the OBCA contains a securities transfer regime whereas the NSCA has no such regime.

Ontario should take a page from leading corporate law jurisdictions in the U.S. such as Delaware and Nevada. The OBCA should continually strive to make itself competitive and attractive to investors, including foreign investors. Foreign investors should not be forced to structure their transactions through jurisdictions that otherwise have little or no connection to the Canadian operations or the place where the acquisition, divestiture, financing or corporate reorganization is run. Foreign investors should not be forced to adopt unnecessarily complex corporate structures, use archaic corporate statutes, retain extra sets of lawyers and incur additional transaction costs if these can all be avoided. Ontario could offer an attractive alternative to the NSULC and thereby send a strong signal that Ontario is the best point of entry for foreign capital.

4. It is Not Necessary to Create a Separate Statute for an Ontario ULC Regime. A Set of Amendments to the OBCA Would Suffice

Like the UK statute upon which it is based, the NSCA sets out the rules governing the NSULC within the same statute that provides for ordinary companies, that is companies limited by shares. There is, therefore, no need to create a separate statute and duplicate many of the rules that would apply to both unlimited corporations and limited corporations. As will be seen, the number and scope of amendments that would have to be made to the OBCA are few. Ontario can easily provide for unlimited corporations through amendments to the OBCA. Indeed, the Corporate Law Subcommittee of the OBA has already prepared the necessary amendments to the OBCA to insert the ULC into Ontario law. See Appendix A for these draft provisions.

#### **IV. RECOMMENDATIONS**

The fundamental recommendation is that Ontario should permit the formation of ULCs. The remaining discussion focuses on the mechanics of implementing Ontario ULC legislation.

A few essential amendments would have to be made to the OBCA to provide for the ULC. Some other amendments are optional but would enhance its attractiveness to foreign

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<sup>57</sup> OBCA, s. 20(3)(c).

investors. Finally, there are some provisions of the NSCA that should not be replicated in the OBCA.

1. Essential Amendments

- (a) The OBCA would have to make a distinction between ordinary “limited corporations”, the only type now permitted, and the newly-permitted “unlimited corporations” or ULC. The concept of “corporation” would then include both types.
- (b) Subsection 92(1) of the OBCA states that shareholders of the corporation enjoy limited liability subject to certain enumerated exceptions. The members of an NSULC do not become liable for the residual liabilities of the NSULC except upon winding-up of the NSULC.<sup>58</sup> The same concepts would have to be imported into the OBCA for unlimited corporations. However, to provide added certainty for investors, the circumstances in which shareholder liability arises should be clear. In particular, liability should arise if, but only if, the ULC is liquidated or dissolved under the OBCA (whether voluntarily or involuntarily), it makes a voluntary assignment into bankruptcy under the *Bankruptcy and Insolvency Act*<sup>59</sup> it is petitioned into bankruptcy under the BIA (an involuntary bankruptcy) or it is made subject to a winding-up order under the *Winding-Up and Restructuring Act*.<sup>60</sup> Liability should not arise merely because the ULC seeks to reorganize its business and financial affairs by way of a proposal under Part III of the BIA, a plan of arrangement under the *Companies’ Creditors Arrangement Act*<sup>61</sup>, a plan of arrangement under the *Winding-Up and Restructuring Act* or an arrangement or reorganization under the OBCA. Liquidation should be differentiated from a financial reconstruction designed to salvage and resurrect the business of a corporation.
- (c) To protect the public, third parties dealing with a corporation would have to have an easy way of knowing whether the corporation with which they are dealing is a limited or an unlimited corporation. If a person deals with a corporation in the mistaken belief that he or she is dealing with an unlimited corporation whereas he or she is in fact dealing with a limited corporation, that person could be unfairly prejudiced. Currently, “limited”, “incorporated” or “corporation”, or their respective abbreviations, must be included in the corporate name of an OBCA corporation.<sup>62</sup> The OBCA should provide a different legal element to differentiate unlimited corporations from limited corporations. For instance, the terms “unlimited corporation” or “unlimited company” or the abbreviation, “”ULC” or

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<sup>58</sup> NSCA, s. 135.

<sup>59</sup> R.S.C. 1985, c. B-3 (hereinafter, the “BIA”).

<sup>60</sup> R.S.C. 1985, c. W-11.

<sup>61</sup> R.S.C. 1985, c. C-36.

<sup>62</sup> OBCA, s. 10(1).

could be earmarked for the ULC.<sup>63</sup> Existing OBCA corporations would then not have to change their corporate names. No Ontario ULC yet exists, so there is no prejudice or inconvenience. Under the NSCA, an NSULC cannot use the legal elements “limited” or “incorporated” or abbreviations thereof in a name.<sup>64</sup> In addition to the legal element, “company”, an NSULC is permitted to use “corporation” or its abbreviation in its corporate name.

- (d) A method for converting a limited corporation into a ULC, and *vice versa*, must be introduced into the OBCA. However, the method need not follow the method used in the NSCA for converting a company limited by shares into a NSULC. The requirement of a statutory amalgamation is problematic. An amalgamation automatically triggers a financial year-end for tax purposes for each of the amalgamating companies and carries with it the consequent acceleration of any non-capital loss carryforwards.<sup>65</sup> Instead of an amalgamation, a limited corporation might be converted into a ULC by certificate and articles of amendment, requiring a two-thirds favourable vote of each class of shares. Since the corporation would have to change its name in any event, the additional requirement for articles of amendment imposes no material added burden on the corporation. Alternatively, the conversion might require a certificate and articles of continuance. A limited corporation could continue as a ULC or *vice versa*.
- (e) Where a limited corporation converts into a ULC or the reverse, all of the shareholders should have a dissent and appraisal right so that they can opt-out of the corporation and receive fair value for their shares without incurring the risk of personal liability.

## 2. Desirable but Optional Amendments

- (a) Since the shareholders of a ULC have unlimited liability, creditors do not have the same legitimate concern if the corporation holds shares in its parent as applies where the shareholders are immune from liability. Both the subsidiary and the parent would ultimately be liable to any creditors. Thus, the prohibition against subsidiaries owning shares in a parent could be made inapplicable to a ULC,<sup>66</sup> removing one more disincentive to incorporating the ULC under the OBCA.

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<sup>63</sup> However, many partnerships and proprietorships already use “company” or “co.”. Thus, these words should not be used to denote the ULC.

<sup>64</sup> The naming convention represents the practice of the Nova Scotia Registrar of Joint Stock Companies. The NSCA is silent as to what names are prescribed for the NSULC and what names are prohibited. The legal elements “limited”, “incorporated” and abbreviations thereof are prescribed for companies limited by shares and companies limited by guarantee. Thus, the public policy of avoiding overlap in the legal elements permitted to the NSULC and the other types of companies is implemented through administrative practice rather than through the NSCA itself.

<sup>65</sup> See, however, the E.L. Management decision, *supra*, note 31.

<sup>66</sup> OBCA, s. 28(1).

- (b) Consideration should also be given to exempting the ULC from the requirement to satisfy various solvency tests set out in the OBCA<sup>67</sup> before completing certain transactions which have the effect of depleting assets required to satisfy claims of creditors. For example, currently, an OBCA corporation is precluded from declaring or paying dividends (other than stock dividends, which, by their nature, do not result in any dissipation of underlying assets) unless, following the declaration and payment, the corporation will still be able to pay its liabilities as they become due and the realizable value of the assets of the corporation will still exceed its liabilities and stated capital of all classes.<sup>68</sup> The purpose of the rule is to ensure that creditors are not prejudiced by the declaration and payment of dividends to shareholders. Again, the same concern does not exist when the shareholders of the company have unlimited liability. Even if the company is insolvent, the shareholders ultimately remain liable for the debt. The same analysis can be made to the application of the solvency tests where the ULC purchases or otherwise acquires its own issued shares, redeems its shares, enters into a contract to repurchase its shares or reduces its stated capital. Since the shareholders of the unlimited company ultimately remain liable, the legitimate concern about the dissipation of corporate assets prejudicing the rights of creditors is reduced, if not eliminated.
- (c) It would be worthwhile to require the ULC to set out a notice or warning in share certificates representing shares in the ULC (whether issued from treasury to a subscriber or representing shares transferred to a purchaser or other transferee) that he or she may incur personal liability to the creditors of the ULC upon registration of his or her interest in the ULC. Also, before the shares are registered in the name of the subscriber or transferee, he or she should have the statutory right to obtain the most current financial statements of the ULC so that he or she can assess the risk entailed in unlimited liability. There are no comparable protective provisions under the NSCA.
- (d) As stated above, the whole rationale for allowing the ULC as a form of corporation is create an attractive vehicle for foreign investors. The ULC has no current appeal to purely domestic investors. Thus, consideration should be given to exempting the ULC from the requirement that it have any resident Canadian directors on its board<sup>69</sup> or on any board committees.<sup>70</sup> In part, the change would respond to the new Canadian residency requirements under the CBCA. Under the CBCA, the usual Canadian residency requirement<sup>71</sup> has been reduced from a

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<sup>67</sup> OBCA, s. 30(2) (purchase of issued shares), s. 31(3) (purchase of issued shares), s. 32(2) (share redemption), s. 34(4) (reduction of stated capital), s. 38(3) (dividends), s. 185(30) (purchase of shares under dissent remedy) and s. 248(6) (purchase of shares under oppression remedy).

<sup>68</sup> OBCA, s. 38(3).

<sup>69</sup> OBCA, s. 118(3).

<sup>70</sup> OBCA, s. 127(2).

<sup>71</sup> CBCA, s. 105(3.1).

majority to not less than 25%. If the main reason for continuing to insist on a Canadian resident component on the board is so that there is at least one Canadian resident who can be liable for certain statutory liabilities such as unpaid employee wages or withholding taxes, then certain realities should be understood. First, more than half of all Canadian jurisdictions no longer have any Canadian residency requirement. Five provinces (Quebec, Nova Scotia, New Brunswick, Prince Edward Island and British Columbia) and all three territories do not impose any such requirement.<sup>72</sup> Second, through the unanimous shareholder agreement or declaration in lieu of unanimous shareholder agreement, all of the duties and liabilities of the members of the board can be transposed to the shareholders.<sup>73</sup> Thus, the board of an OBCA corporation can already be relieved of these liabilities. Third, the shareholders of a ULC would, *ex hypothesi*, have unlimited liability for the debts of the ULC on winding-up. Generally, shareholders are not liable for the debts of their company, which is one reason why liability is imposed on directors.

- (e) Since the ULC will generally be owned entirely by U.S. investors, the normal rule requiring that the financial statements be prepared in accordance with Canadian generally accepted accounting principles<sup>74</sup> could be relaxed so as to permit their preparation in accordance with U.S. GAAP.<sup>75</sup> The ITA will continue to require that financial statements be prepared in accordance with Canadian GAAP for tax purposes.<sup>76</sup> Thus, there is no harm in allowing U.S. shareholders to receive financial statements in a manner that suits them.
- (f) There is no prejudice to third parties if a limited corporation is converted into a ULC. The only possible prejudice is where a third party, thinking it is dealing with a ULC and that it can look to the shareholders for any shortfall upon insolvency of the ULC, continues dealing with the corporation on that basis and only finds out later that the corporation has been converted into a limited corporation. The solution would be to deny the directors and shareholders of the corporation limited liability protection unless they bring to the attention of parties dealing opposite to the corporation that they are no longer dealing with a ULC or unless personal liability is expressly excluded in the contract between the ULC and the opposite contracting party. The appropriate rules already exist under s.10 (5) of the OBCA and s. 2 (6) of the *Business Names Act*.<sup>77</sup> Unless a director or officer of a corporation brings to the attention of the opposite party that he or she is operating on behalf of a limited corporation, limited liability protection will be

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<sup>72</sup> Jurisdiction Shopping, *supra* note 23, at 2-2.

<sup>73</sup> OBCA, s. 108(5).

<sup>74</sup> Generally accepted accounting purposes, whether Canadian or U.S., are hereinafter referred to as "GAAP".

<sup>75</sup> General Regulations made under the *Business Corporations Act*, R.R.O. 1990, Reg. 62, s. 40.

<sup>76</sup> ITA, s. 181 (3)(b)(i).

<sup>77</sup> R.S.O. 1990, c. B.17 [hereinafter, the "BNA"].

unavailable.<sup>78</sup> The same principle should apply to unannounced or secretive conversions of ULCs into limited corporations. An amalgamation that does not result in a name change does not drive home to the opposite party that there has been a conversion of a NSULC into a company limited by shares. What drives the point home is the legal element in the corporate name.

### 3. Undesirable Amendments

There are certain provisions of the NSCA that can be discarded if Ontario were to permit the formation of ULCs.

- (a) As discussed, the cumbersome method of converting a company limited by shares into a ULC need not be imported as part of the OBCA. There should be a corporate name change, either articles of amendment or articles of continuance and notice to shareholders and creditors.
- (b) The NSCA still permits the flexibility of having partly-paid shares or shares issued in whole or in part in exchange for a promise to pay.<sup>79</sup> The OBCA abolished partly-paid shares and consideration in the form of the subscriber's promise to pay in 1971. The abolition of partly-paid shares facilitates the treatment of shares in a corporation as a species of negotiable instrument. It removes the concern that, by becoming a registered shareholder, the subscriber or purchaser of the shares may become liable for the unpaid portion of the original subscription price. Allowing partly paid shares, however, might seriously undermine the overall marketability of shares in Ontario corporations. Although a case could be made for allowing a ULC to issue partly paid shares or shares issued in exchange for a promise to pay, there is no compelling need to do so. The ULC is not used as a vehicle for public investment. It is entirely a closely-held investment vehicle. Nothing should be done to undermine the marketability of shares in Ontario corporations or to raise concerns as to personal liability for shares acquired in an Ontario corporation, particularly since it would be possible for the corporation to change its status from that of a ULC to a limited corporation.
- (c) The NSCA still allows a corporation the option of using par value shares or non-par value shares. The OBCA abolished the concept of par value shares in 1971. It was found to be misleading to investors.<sup>80</sup> There is no need for the

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<sup>78</sup> See the long line of Ontario cases which includes: *Truster v. Tri-Lux Fine Homes Ltd.* (1998) 18 R.P.R. (3.1) 1, 39 C.L.R. (2d) 6 (Ont. C.A.), *Pennelly Ltd. v. 449483 Ontario Ltd.* (1986) 20 C.L.R. 145 (Ont. H.C.J.), *Joel Theatrical Rigging Contractors (1980) Ltd. v. Szilva* (1989) 23 A.C.W.S. (3d) 389 (Ont. Dist. Ct.), *Watfield International Enterprises Inc. v. 655293 Ontario Ltd.* (1995) 21 B.C.R. (2d) 158 (Ont. Gen. Div.), *573521 Ontario Inc. v. Waldman* (1996) 31 C.L.R. (2d) 305 (Ont. Gen. Div.), *Clow Darling Ltd. v. 1013983 Ontario Inc.* (1997) 36 B.L.R. (2d) 137 (Ont. Gen. Div.), *Partners Catering Inc. v. Aboya* (1998) 84 A.C.W.S. (3d) 489 (Ont. Gen. Div.) and *Commercial Tire Supply Ltd. v. Tunney*, 2000 Carswell Ont. 4811 (S.C.J.).

<sup>79</sup> NSCA, s. 109(2).

<sup>80</sup> *Dickerson Report*, para 98-100.

OBCA to reintroduce the concept of par value shares even if they were limited to the ULC.

- (d) There is no need to adopt the NSCA rule requiring that amalgamations be approved by court order. The ULC should put third parties on notice that they are dealing with a ULC. As stated, both s. 10(5) of the OBCA and s. 2(6) of the BNA already so provide. A court order (which in practice is almost invariably granted *ex parte*) does not furnish meaningful notice to any third parties.
- (e) While the NSCA allows classes of shares to be created by resolution that need not be filed until after issuance of the shares, the concept would be too foreign to the OBCA to be adopted. Under the OBCA, a class of shares can only be created by articles of amendment, articles of amalgamation, articles of arrangement, articles of reorganization or articles of continuance. The shares can only be issued once they have been created. These procedures have not proven onerous. Indeed, the “no creation until filed” requirement eliminates the potential problem of what happens if the amendments to a corporation’s share capital are never filed. The number of unimportant distinctions between limited corporations and ULCs should be minimized.
- (f) While there may be value in requiring that share certificates of a ULC contain a notice warning the subscriber or transferee that registration carries the risk of unlimited personal liability, there is no point in adopting the NSCA requirement that the preferred share conditions be set out in their entirety in share certificates.

4. A Red Tape Reduction Bill is an appropriate statutory vehicle for introducing the Ontario ULC

As discussed, the sole rationale for introducing the ULC into Ontario is to facilitate direct foreign investment into not only Ontario but all of Canada. The Ontario ULC would offer a number of advantages for foreign investors in comparison to the NSULC. Apart from the technical advantages that the OBCA would afford to foreign investors, an Ontario ULC would primarily serve to give foreign investors an alternative to channelling their investments through Nova Scotia. An Ontario ULC regime will not prevent foreign investors from continuing to use the NSULC if that is their choice. However, an avoidable layer of additional complexity and expense should not be considered an acceptable cost of doing business in Canada. If complexity and cost can be eliminated, they should be. Ontario, as the financial capital of the country, should signal that it welcomes foreign investment and strives to create an efficient, straightforward corporate regime to facilitate it. Allowing for the ULC in Ontario is entirely consistent with the philosophy inherent in reducing red tape.

**V. ULC AS AN ELEMENT OF ONTARIO’S COMMERCIAL LAW COMPETITIVE STRATEGY**

With increasing globalization, it is no longer enough for our legislators to assess their commercial law infrastructure in terms of sister provinces. Rather, Ontario’s legal

infrastructure is now being assessed in terms of those prevailing in the world financial centres, primarily, New York, London and Frankfurt.

Ontario is blessed with some natural competitive advantages. These include its stable political and economic environment, its governance by the rule of law, its sound financial institutions, an educated workforce, its linguistic and multi-ethnic diversity and a strong commercial law bench and bar.

Unfortunately, if we look closely at the state of our commercial laws, it appears that Ontario may be losing ground to other major financial centres. The question is whether our elected representatives in Ontario are doing all that they can to maintain Ontario as a globally competitive financial and commercial jurisdiction. A ULC regime in Ontario is an integral part of several steps that ought to be taken to rebuild Ontario's commercial law competitiveness. As stated, ULCs provide U.S. investors with favourable U.S. tax treatment and have become the vehicle of choice for large-dollar direct U.S. investment into Canada. There is no loss of Canadian tax revenue from allowing the formation of ULCs. There is no reason why Ontario could not offer U.S. investors an Ontario ULC so as to simplify their life and signal that Ontario is open for business.

There are a finite number of other elements to rebuilding Ontario's commercial law infrastructure.

The most obvious deficiency in our current commercial law is the absence of a uniform statute governing the transfer and pledge of investment securities. Such a law forms a crucial underpinning for our otherwise-sophisticated securities settlement system, which handles daily transactions averaging around CAN\$100 – \$150 billion.

We currently have a patchwork of inconsistent and incomplete rules contained in numerous federal and provincial corporate statutes. These rules fail to address the securities of non-corporate issuers such as governments, crown agencies, limited partnerships, real estate investment trusts and income trusts. They make transactions unnecessarily difficult and expensive, generally reducing efficiency and competitiveness.

In contrast, the United States has had uniform securities transfer laws for over 50 years, and its 1994 revisions (adopted uniformly by all 50 states) make it the most advanced law in the world of its type. In light of the obvious advantages for Canada to have similar uniform laws and the availability of a comprehensive proposal to provide such laws almost immediately, this is a commercial-law subject that should command more attention and support from government –especially Ontario.

In 2001, the federal government enacted a wholesale reform of the CBCA. As a result, the CBCA leaped ahead of the OBCA in several key areas. These include residency requirements for directors, financial assistance, indemnification of directors and officers, shareholder proposals and unanimous shareholder agreements. Ontario, for example, is one of the last remaining jurisdictions in the country that still generally requires that a majority of board members be resident Canadians. As discussed, other provinces have removed this requirement including, most recently, British Columbia, in its new statute.

Ontario is one of the last of two jurisdictions in Canada to keep bulk sales laws on its books. The only other holdout is Newfoundland and Labrador. Bulk sales laws increase the compliance costs of completing business acquisitions through asset purchases. It is turn of the 20<sup>th</sup> century legislation that, in Ontario, has made it into the 21<sup>st</sup> century.

In recent years, investors have made increased use of non-corporate or alternative business vehicles primarily for tax reasons. Alternative business vehicles include partnerships, limited partnerships, joint ventures, ULCs, real estate investment trusts, resource royalty trusts and income trusts. The law governing partnerships and limited partnerships has been fundamentally unchanged since the 1890s. Hence, partnerships are still not generally recognized as legal entities. Much uncertainty surrounds the extent to which limited partners can change a general partner or otherwise influence the direction of the firm without loss of their limited liability shield.

The situation confronting business trusts is even worse. In contrast to the U.S., Ontario still not resolved many fundamental legal issues concerning the now popular business trust as an investment vehicle. These issues include beneficiary liability, the liability of trustees to creditors, the right of trustees to indemnification out of trust assets and the rights of unsecured creditors to look directly to the assets of a trust. Furthermore, it is ironic that, as rules concerning corporate governance have become tougher in the wake of the *Sarbanes-Oxley Act*, nothing has been done to replicate the laws on corporate governance for alternative business vehicles such as the business trust. Comprehensive legislation governing business trusts only exists south of the boarder. On July 1, 2004, Alberta's new *Income Trusts Liability Act*<sup>81</sup> went into force. Meanwhile, Ontario's equivalent legislation, the *Trust Beneficiaries Liability Act*,<sup>82</sup> is still not yet law. In July 2004, Alberta released a discussion paper on income trust governance and legal status issues. Again, Alberta has taken the legislative lead in an area where Ontario dominates the commercial practice.

For many years, Ontario has gone its own way with respect to its *Personal Property Security Act*,<sup>83</sup> the principal statute governing the creation, registration and enforcement of security interests in personal property. One fundamental difference between Ontario and the remaining Canadian common law jurisdictions is the characterization of equipment leases as secured transactions. Outside Ontario, the remaining common law jurisdictions provide that, where an equipment lease is for a term of more than one year, it creates a security interest and is governed by the same legislation that governs other security interests. In Ontario, there is no such clear rule. The result of this disharmony was recently demonstrated in an Ontario Court of Appeal decision, *GMAC Commercial Credit Corp. v. TCT Logistics Inc.*,<sup>84</sup> where an equipment lessor registered in Ontario but not in the relevant province and then had to argue that the equipment lease should be dealt with under Ontario law as a true lease. Had Ontario harmonized its laws with the remaining provinces, the case would never have come to court.

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<sup>81</sup> Alberta Bill 34.

<sup>82</sup> Bill 106, An Act to Implement Budget Measures and Amend the *Crown Forest Sustainability Act*, 2004.

<sup>83</sup> R.S.O. 1990, c. P.10.

<sup>84</sup> S.O. 2002, c. 24, Sched. B.

One aspect of the new Ontario *Limitations Act*, 2002<sup>85</sup> which came into force on January 1, 2004, has reduced Ontario's attractiveness as a commercial and business centre. While many of the features of the new law are salutary, it contains a controversial provision stating that a "limitation period under [the] Act applies despite any agreement to vary or exclude it". The result has been an exodus of some commercial transactions from Ontario so that, where possible, the contracting parties can contract as they please and avoid the uncertainty that the new Ontario legislation casts on their private agreements.

It is easy to overlook the significance of commercial laws, but they are crucial to our financial and commercial infrastructure. They are important not only to Ontarians but also to all Canadians. For better or worse, Ontario will remain the leading financial and commercial jurisdiction within the country and the principal entry point for foreign investment and trade.

Our legislators should be doing everything they can to keep Ontario competitive by international standards. They should certainly not let Ontario's commercial law infrastructure fall into the sad state of disrepair that has become evident. Adopting ULC legislation would be an excellent first step.

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This submission was originally prepared by Wayne D. Gray, a partner at McMillan Binch LLP, Toronto for the Corporate Law Subcommittee of the Business Law Section, Ontario Bar Association and was approved by the OBA Business Law Section Executive on November 9, 2004. Any questions or comments should be directed to:

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<sup>85</sup> (2004), 70 O.R. (3d) 321, 238 D.L.R. (4<sup>th</sup>) 487.

## Appendix “A”

# PROPOSED ULC AMENDMENTS TO THE “BUSINESS CORPORATIONS ACT (ONTARIO)”

## PART I – DEFINITIONS AND APPLICATION

### **Definition of “corporation” in s.1(1):**

The definition of “corporation” is replaced to read: “corporation” means either a limited corporation or an unlimited corporation;

### **Definition of “limited corporation” in s.1(1):**

A definition of “limited corporation” is added to read: “limited corporation” means a body corporate with share capital to which this Act applies other than an unlimited corporation;

### **Definition of “liquidation event” in s.1(1):**

A definition of “liquidation event” is added to read: “liquidation event” means an event specified in subsection 243(1.1) except as otherwise provided in subsection 243 (1.4);

### **Definition of “unlimited corporation” in s.1(1):**

A definition of “unlimited corporation” is added to read: “unlimited corporation” means a body corporate with share capital to which this Act applies, the articles of which provide that, on a liquidation event, the shareholders of the corporation are, as shareholders, liable for any unpaid debts and liabilities of the corporation provided for in this Act;

## PART II – INCORPORATION

### **5(6)**

#### **Unlimited Corporation**

Section 5(6) is added to read: 5(6) The articles of a corporation none of the outstanding shares of which are listed and posted for trading on any stock exchange in Ontario recognized by the Commission and in respect of the shares of which a prospectus or a statement of material facts has not been filed under the *Securities Act* or any predecessor thereof may provide that, on a liquidation event, the shareholders are, as shareholders, liable for any unpaid debts and liabilities of the corporation to the extent provided for in this Act.

### **10(1)**

#### **Use of Legal Element by Limited Corporation**

Section 10(1) is replaced to read: 10(1) The word “Limited”, “Limitée”, “Incorporated”, “Incorporée” or “Corporation” or the corresponding abbreviation “Ltd.”, “Ltée”, “Inc.” or “Corp.” shall be part, in addition to any use in a figurative or descriptive sense, of the name of every limited corporation, but a limited corporation may be legally designated by either the full or the abbreviated form.

**10(1.1)****Use of Legal Element by Unlimited Corporation**

Section 10(1.1) is added to read: 10(1.1). The words “Unlimited Corporation”, “Corporation Unlimitée”, “Unlimited Company” “Companie Unlimitée”, or “Unlimited Liability company” or the corresponding abbreviations “UC”, “CU” or “ULC” shall be part, in addition to any use in a figurative or descriptive sense, of the name of every unlimited corporation, but an unlimited corporation may be legally designated by either the full or the abbreviated form.

**11(1)****Unauthorized use of “Limited Corporation”, etc. Legal Element**

Subsection 11(1) is replaced to read: 11(1). No person, other than a limited corporation, shall trade or carry on a business or undertaking under a name in which “limited”, “limitée”, “incorporated”, “incorporée”, or “corporation” or any abbreviation thereof, or any version thereof in another language, is used.

**11(1.1)****Unauthorized use of “Unlimited Corporation”, etc. Legal Element**

Subsection 11(1.1) is added to read: 11(1.1). No person, other than an unlimited corporation, shall trade or carry on a business or undertaking under a name in which “unlimited corporation”, “corporation unlimitée”, “unlimited company”, “companie unlimitée”, or “unlimited liability company” or any abbreviation thereof, or any version thereof in another language, is used.

**11(2)****Idem**

Section 11(2) is replaced to read: 11(2). Where a corporation carries on business or identifies itself to the public by a name or style other than as provided in the articles, that name or style shall not include the words “limited”, “limitée”, “incorporated”, “incorporée”, “corporation”, “unlimited corporation”, “corporation unlimitée”, “unlimited company”, “companie unlimitée”, or “unlimited liability company” or any abbreviation thereof or any version thereof in another language.

**PART VI - CORPORATE SECURITIES****56.****Contents of share certificate**

- (1) There shall be stated on the face of each share certificate issued by a corporation:**
- (a) the name of the corporation;
  - (b) the words “Incorporated under the law of the Province of Ontario”, “Subject to the *Ontario Business Corporations Act*” or words of like effect;
  - (c) the name of the person to whom it was issued;
  - (d) the number and class of shares and the designation of any class or series that the certificate represents; and
  - (e) in the case of an unlimited corporation, that the shareholder is liable for the debts and liabilities of the corporation on a liquidation event to the extent provided for in the Act.

## **PART VII – SHAREHOLDERS**

### **92**

#### **Shareholders' liability limited**

Subsection 92(1) is replaced to read: 92. (1) Shareholders' subsections liability limited - The shareholders of a corporation are not, as shareholders, liable for any act, default, obligations or liability of the corporation except under subsection 34(5), subsection 92(1.1), subsection 108(5), subsection 130(4) or (5), or section 243.

### **92(1.1)**

#### **Unlimited Corporation**

Subsection 92(1.1) is added to read: 92.(1.1) Notwithstanding subsection (1), the shareholders of an unlimited corporation are, as shareholders, also liable for any unpaid debts and liabilities of the corporation on a liquidation event.

### **92(1.2)**

#### **Effect of Conversion**

Subsection 92(1.2) is added to read: 92.(1.2) The conversion of an unlimited corporation into a limited corporation shall not affect any debts, liabilities, obligations or contracts incurred or entered into by or with the corporation:

- (a) before the conversion;
- (b) or any debts, liabilities, obligations or contracts incurred or entered into by or with the corporation after the conversion unless adequate notice of the conversion has been brought to the attention of any person who dealt with the corporation prior to such conversion

## **PART XVI - FUNDAMENTAL CHANGES**

### **168(1)**

#### **Amendments**

Subsection 168(1) is amended to delete paragraphs (g), (h) and (i) and substitute the following paragraphs:

- (g) change the designation of all or any of its shares;
- (h) change the shares of any class or series, whether issued or unissued, into the same or a different number of shares of other classes or series;
- (i) divide a class of shares, whether issued or unissued, into series and fix the number of shares in each series;
- (o) add or remove a provision in the articles that, on a liquidation event, the shareholders of the corporation are, as shareholders, liable for any unpaid debts and liabilities of the corporation to the extent provided for in this Act.

**185****Rights of Dissenting Shareholders**

Subsection 185(1) is amended to add the following: 185(1) Rights of dissenting shareholders:

- (b.1) amend its articles under section 168 to add a provision to the articles that, on a liquidation event, the shareholders of the corporation are, as shareholders, liable for any unpaid debts and liabilities of the corporation to the extent set out in this Act;
- (d) be continued under the laws of another jurisdiction under section 181 except the *Canada Business Corporations Act* or the prescribed statute of a province or territory of Canada;
- (d.1) be continued as a co-operative corporation under section 181.1;
- (f) carry out a squeeze-out transaction.

**243(1.1)****Liquidation of unlimited corporation**

243(1.1) In the event of a liquidation relating to an unlimited corporation, every past and present shareholder shall, subject to this subsection, be liable to contribute to the assets of the unlimited corporation to an amount sufficient for payment of its debts and liabilities and for the costs, charges and expenses of the bankruptcy, liquidation, dissolution or winding up and for adjustments of the rights of the shareholders among themselves, subject to the following rules:

- (a) a past shareholder shall not be liable to contribute if he or she has ceased to be a shareholder for not less than one year before the date of the liquidation event;
- (b) a past shareholder shall not be liable to contribute in respect of any debt or liability of the corporation contracted after he or she ceased to be a shareholder;
- (c) a past shareholder shall not be liable to contribute unless it appears to the court that the existing shareholders are unable to satisfy the contributions required to be made by them in pursuance of this Act;
- (d) nothing in this Act shall invalidate any provision contained in any contract or instrument whereby the liability of any party to the contract is restricted or whereby the funds of the unlimited corporation are alone made liable in respect of the contract or instrument; and
- (e) a sum due to any shareholder of the unlimited corporation, in his or her capacity as a shareholder, by way of dividend, distribution of monies or other assets on a liquidation or otherwise, may be taken into account for the propose of the final adjustment of the rights and obligations of the contributories among themselves.

**Liquidation event**

(1.2) A liquidation event means:

- (a) the bankruptcy of an unlimited corporation under the *Bankruptcy and Insolvency Act* (Canada);
- (b) a liquidation of the unlimited corporation under the *Winding-up and Restructuring Act* (Canada);
- (c) a liquidation or dissolution of the unlimited corporation this Part; or
- (d) a winding-up of the unlimited corporation under clause 248(3)(l) of this Act.

**Date of liquidation event**

(1.3) A liquidation event occurs on the date:

- (a) an assignment or receiving order is made under the *Bankruptcy and Insolvency Act* (Canada);
- (b) a proposal under Part III of the *Bankruptcy and Insolvency Act* (Canada) is defeated;
- (c) a corporation is dissolved under Part XVI; or
- (d) a liquidation or winding-up under the *Winding-up and Restructuring Act* (Canada) or this Act, as the case may be, commences.

**Excluded events**

(1.4) Subsection (1.1) does not apply to:

- (a) a proposal under Part III of the *Bankruptcy and Insolvency Act* (Canada) unless the proposal is defeated;
- (b) a reorganization of the unlimited corporation under the *Companies Creditors' Arrangement Act* (Canada); or
- (c) a reorganization of an unlimited corporation under the *Winding-up and Restructuring Act* (Canada),

unless the court hearing the matter orders otherwise.

**(2) Party Action**

The court may order an action referred to in subsection (1) or brought to enforce an obligation under subsection (1.1) to be brought against the persons who were shareholders as a class, subject to such conditions as the court thinks fit and, if the plaintiff establishes his, her or its claim, the court may refer the proceedings to a referee or other officer of the court who may:

- (a) add as a party to the proceedings before him or her each person who was a shareholder found by the plaintiff; and
- (b) determine, subject to subsections (1) and (1.1), the amount that each person who was a shareholder shall contribute towards satisfaction of the plaintiff's claim; and
- (c) direct payment of the amounts so determined.