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secured lending in Canada

Free trade and global competition have created new opportunities for US businesses in Canada. As a result, both US and Canadian businesses and financial markets enjoy far greater interaction. The following summarizes significant Canadian legal issues that a US lender should be aware of when considering whether to underwrite or participate in a credit involving Canadian assets.

Regulatory Matters

The federal Bank Act does not prohibit a foreign bank or lender operating outside Canada from either lending to a debtor located in Canada or taking security in assets located in Canada. Generally, these entities may take such action as long as the substantive negotiations between the lender and the debtor take place outside Canada, the transaction is completed outside Canada and the lender does not carry on business through an office, employee, agent or nominee located in Canada.

Under the federal regulatory framework, a foreign bank wishing to have a presence in Canada has several options. A qualifying foreign bank can carry on its wholesale banking business in Canada directly through a branch. The other options are the establishing of a foreign bank subsidiary or the maintaining of a representative office in Canada. The latter is limited to promoting the services and acting as a liaison with clients of the foreign bank. Foreign bank subsidiaries have the status of Canadian chartered banks and are regulated like their domestic counterparts. Foreign bank branches are regulated in a manner parallel to the domestic regulatory scheme.

Tax

Withholding Tax

Canada generally imposes a 10% withholding tax on interest that a Canadian resident debtor pays to a US lender entitled to the benefits of the Canada-United States Income Tax Convention (1980), as amended. (Note, however, that Canadian tax authorities do not allow US limited liability companies to use these benefits.)

Under Canadian legislation, a withholding tax exemption is available for debt that Canadian resident corporations owe to arm's length non-residents. To be exempt, the debtor cannot be required, by the terms of the obligation, to repay more than 25% of the original principal amount within five years from the date the obligation is issued. Term loans from US lenders to Canadian corporations generally are structured to fall within this exemption. Nevertheless, credit agreements for such loans usually include "gross-up" provisions to ensure that the debtor must compensate the lender if Canadian withholding tax is exigible.

Typically, withholding tax also must be paid on the interest component of payments made by a Canadian resident guarantor to a US lender under a guarantee of a Canadian borrower's indebtedness, unless the indebtedness qualifies for the above-mentioned five-year exemption. As with credit agreements, guarantees commonly include a "gross-up" provision in favour of the lender.

Thin Capitalization Rules

US lenders sometimes lend to a US corporation which, in turn, lends those funds to its Canadian subsidiary. Thin capitalization rules under Canadian tax legislation determine whether the subsidiary may deduct interest on the amount borrowed from the US parent. Essentially, the rules prevent Canadian subsidiaries from deducting interest on the portion of loans from a US parent that exceeds two times the subsidiary's equity (retained earnings and share capital and contributed surplus attributable to specified non-residents). The same rule applies equally to other interest-bearing loans to Canadian subsidiaries from "specified non-residents". The thin capitalization rules generally do not apply to a direct loan from an arm's length US lender.

Legislative Framework for Taking Security

In Canada, provincial legislation generally governs the creation and enforcement of security. (A notable exception is security granted to banks under the federal Bank Act, discussed in greater detail below.) Provincial registry and land titles systems govern security against real property, whereas provincial personal property security legislation governs security against personal property.

PPSA Jurisdictions

Most Canadian provinces have adopted comprehensive personal property security legislation (PPSA) resembling Article 9 of the United States Uniform Commercial Code (UCC). The PPSA regulates the creation, perfection and enforcement of a security interest in a debtor's assets, and creates a system for determining the priority of competing interests in collateral. The act applies to any transaction that creates a security interest in personal property, regardless of the form of document used to grant the interest.

Under the PPSA, "security interest" is defined as an interest in personal property that secures payment or performance of an obligation. "Personal property" encompasses virtually all types of personal property. In most cases, the creditor perfects the security interest by registering a financing statement.

Most Canadian lenders in PPSA jurisdictions use a general security agreement covering all of the debtor's existing and after-acquired assets. A general security agreement typically does not extend to real property. Rather, a separate mortgage of lands commonly secures the real property. To create security in both real and personal property, the creditor may use a debenture which combines both a real property and personal property charge in the same document. Other security agreements may be limited to specific types of personal property, such as inventory, equipment or receivables.

Non-PPSA Jurisdiction

Quebec, Canada's only civil law jurisdiction, has a European style Civil Code that codifies the province's general principles of law. The hypothec, Quebec's main form of security, may be granted by a debtor to secure any obligation, and may create a charge on existing and after-acquired movable or immovable property. It may be made with or without delivery, allowing the grantor to retain certain rights to use the property.

Bank Act Security

Section 427 of the Bank Act provides a particular type of security available to only Canadian chartered banks and foreign bank subsidiaries incorporated under the Bank Act. The section entitles the bank to take security, from certain classes of debtors, against articles the debtor deals in, produces or uses in the course of its particular business. The debtor classes include manufacturers, wholesale or retail purchasers, shippers or dealers, and farmers, fishers and forestry producers.

When a bank takes security under the Bank Act, it must register the security with the Bank of Canada agent in the province where the debtor has its principal place of business. Before the security is granted, the bank must file a statutory form, the Notice of Intention to Grant a Security Interest. Once filed, Section 427 security is

effective across Canada. Lenders may assign their rights and powers in respect of only certain types of property on which Section 427 security has been given.

A major advantage of Bank Act security is that it transfers title to the bank, thus allowing the bank to defeat certain claims that would otherwise take priority, such as a landlord's claim for unpaid rent. There is no clear code governing the relative priorities of competing Bank Act and PPSA security.

Selected Issues in Taking Security in Canada

Security in Government Receivables

Under Canadian federal legislation, subject to prescribed exceptions, receivables owed by the federal government can be assigned only absolutely (not as security) and only with appropriate notice to the government, which must be acknowledged. Some provinces have similar legislation covering receivables owed by the provincial government. In Canada, asset-based lenders frequently exclude government receivables from the borrowing base. In cases involving significant Crown receivables, it may be possible to structure an indirect form of security.

Security in Deposit Accounts

The PPSA permits a lender to take security over deposit accounts that are treated as receivables owed by the depository to the debtor owner. Consequently, lenders in Canada commonly take a security interest in the credit balance of a debtor's deposit account. The PPSA provides that security interests in deposit accounts are perfected by registering a financing statement.

Lock-Boxes and Blocked Accounts

Until fairly recently, Canadian debtors obtained working capital credit facilities on a demand basis from Canadian banks, which also served as the debtors' retail banks and cash management services providers. Where the Canadian lender also provided cash management services to the debtor, lock-box and blocked account arrangements served no purpose and were not used. However, two main factors changed this: the growth of asset-based financing by Canadian subsidiaries of US banks and non-banks in Canada, and the lock-box and blocked accounts arrangements that are conventional components of these financings. Through their participation in the establishment and operation of such arrangements, several Canadian banks are now familiar with lock-box and blocked account arrangements.

Pledges of Shares

Canadian lenders generally require debtors to pledge their shares if the debtor is a private company. Under the PPSA, a secured party can perfect its security interest in shares by taking physical possession of the share certificates, registering under the PPSA or both. In Ontario, the practice is to perfect by both possession and registration. A private company's constating documents must include a restriction on the right to transfer its shares. This restriction usually states that each transfer of the company's shares requires approval by the company's directors or shareholders. In light of this restriction, pledged shares often are transferred into the name of the lender or its nominee to better perfect the lender's security in the private company's shares.

Security in Real Property - Title Opinions

In Canada, lenders taking security on real property have the option of relying upon either title insurance or a title opinion from legal counsel. Title insurance, as a viable alternative, is a recent development in Canada and, although resort to title insurance is steadily increasing, title opinions are still more commonly used by Canadian lenders. A title opinion may be provided by counsel for the lender or the debtor and states that the debtor has a good and marketable title to the secured property, subject to encumbrances identified in the opinion.

Legal Opinions

Canadian lenders generally rely on the legal opinions of debtors' counsel as to the enforceability of loan and ancillary documents. Like US counsel, Canadian counsel in practice do not provide opinions on the title to personal property or the priority of personal property security.

Environmental Liability

Secured lenders face three major risks under federal and provincial environmental laws. First, the debtor's financial stability may be threatened by environmental liabilities. Second, the debtor's environmental liabilities may impair

the value of the lender's security. Finally, the lender may itself face exposure for environmental liabilities. This can arise if the lender actually participates in or exercises control over the day-to-day operations or financial management of the polluting business (before or after the appointment of a receiver), or becomes the owner of a contaminated site by foreclosure or similar action.

Interest Act (Canada)

Under the **Interest Act** (Canada), any contract or agreement may stipulate or allow for any rate of interest. However, the contract or agreement must contain an annual interest rate or, in the case of contracts or agreements where the rate or percentage is for a period of less than one year, an express statement of the annual equivalent interest rate. Failure to include an annual interest rate or an annual equivalent interest rate will result in the imposition of an interest rate not to exceed five percent per year. In addition, where contracts or agreements are secured by a mortgage on real property, a higher rate of interest cannot be recovered on amounts in arrears.

Criminal Code (Canada)

Section 347 of the **Criminal Code** (Canada) makes it a criminal offence to receive interest at a criminal rate, defined as an effective annual rate of interest that exceeds sixty percent. Interest in the **Criminal Code** (Canada) is broadly defined to include interest, fees, commissions and similar charges and expenses that a borrower pays in connection with the credit advanced. This section has arisen almost exclusively in civil, not criminal, cases where the borrower seeks to avoid repayment by arguing that the contract was illegal. Courts have struggled with which, if any, contractual provisions should be enforced when a contract imposes a criminal rate of interest.

Guarantees

Canadian laws governing inter-corporate guarantees are quite different from their US counterparts. Generally speaking, the validity of an inter-corporate guarantee will not likely be effectively challenged under either Canadian federal bankruptcy legislation or provincial fraudulent conveyance or preference legislation. In Canada, corporate law provides the primary restrictions on inter-company guarantees. Generally (except in the provinces described below) a Canadian corporation, or its affiliates, may neither directly nor indirectly give financial assistance, by guarantee or otherwise, to members of the inter-company group if there are reasonable grounds to believe the corporation would be unable to meet prescribed solvency tests after giving the assistance. In most cases, exceptions to the general rule include "upstream" guarantees, where a wholly-owned subsidiary assists its parent, and "downstream" guarantees, where a parent assists its subsidiary. However, a number of jurisdictions (British Columbia, Alberta, Saskatchewan and Ontario) have repealed these restrictions and now permit a corporation to give financial assistance by way of guarantee or otherwise to any person for any purpose, provided it discloses material financial assistance to its shareholders after such assistance is given. In addition, the financial assistance restrictions under the federal **Canada Business Corporations Act** have recently been repealed and now parallel the financial assistance provisions in Ontario. Under certain circumstances, a guarantee that disregards the interest of creditors or minority shareholders could be challenged under oppression provisions of Canadian corporate legislation.

Enforcing Security

Before enforcing security, a lender must demand that the debtor repay the loan, and give the debtor reasonable time to do so. The lender must comply with these requirements even if the debtor waived these rights in the loan and security documents. The secured lender (and any receiver it may appoint) must act in good faith and in a commercially reasonable manner when selling or otherwise disposing of the secured assets. The lender also must give advance notice of the intention to realize on security. If the lender fails to meet these obligations at any stage of the enforcement process, it may be liable to the debtor or other creditors for damages.

Priorities Issues

Priming Liens

In Canada, a number of statutory claims may "prime" or take priority over a secured creditor. Priming liens commonly arise from a debtor's obligation to remit

amounts collected or withheld on behalf of the government (for example, unremitted employee deductions for income tax, pension plan contributions and employment insurance premiums and unremitted federal goods and services taxes and provincial sales taxes), or the debtor's direct obligations to the government (for example, municipal taxes and workers' compensation assessments). The relative priority of statutory claimants and secured creditors is greatly affected, and often reversed, by the debtor's bankruptcy.

Subordinated Liens

In Canada, senior secured lenders commonly permit another lender to hold a subordinated security interest in the same collateral. However, the existence of a subordinated lien can complicate matters in a number of ways. First, should the senior lender realize on its security, it must do so in a commercially reasonable manner. The existence of a junior lender in no way alters that obligation. However, as a practical matter, another lender (other than the debtor or the debtor's unsecured creditors) is more likely to challenge the senior lender's actions. Moreover, the junior lender possesses certain technical rights that may otherwise affect realization (for example, notice of disposition of the collateral).

Finally, the junior lender might make it more difficult to successfully reorganize the debtor's debt. For example, corporate reorganization statutes divide the debtor's creditors into classes. Generally, the secured lender has an advantage by being in a class by itself, as this provides the lender with complete control. In most reorganizations, a senior and junior lender are placed in separate classes. However, under some circumstances the senior and junior lender may be placed in the same class. Additionally, a junior lender may ask the court to lift a stay, and thereby effectively end the reorganization attempt. The senior lender may prefer that the stay continue.

Corporate Restructuring Statutes

In Canada, both the Bankruptcy and Insolvency Act (BIA) and the Companies' Creditors Arrangement Act (CCAA) allow debtors to reorganize their affairs. Each act stays creditors from enforcing their claims. Under recent amendments to both statutes, Canadian courts enjoy greater power to co-ordinate local proceedings with any foreign insolvency proceedings involving the debtor.

Bankruptcy and Insolvency Act

The restructuring process begins by filing either a definitive proposal for reorganization or a notice of intention to make a proposal. Once a notice or proposal is filed, all proceedings against the debtor are stayed. Secured creditors are stayed from enforcing their security unless they gave a notice of intention to enforce security more than ten days before the debtor's notice or proposal was filed. Unless an extension is granted, the debtor must file a definitive proposal within 30 days of filing the notice of intention to make a proposal. A debtor who fails to do so is deemed a bankrupt.

The proposal under the BIA may be put to all creditors together, or to unsecured and secured creditors arranged in classes. If grouped, secured creditors with a "commonality of interest" must be in the same class. Although the proposal need not include all creditors, those excluded from the debtor's proposal are not bound by it and may enforce their security during the restructuring process.

The proposal must be accepted by a double majority of the creditors (one-half in number and two-thirds in value) and approved by the court. Once approved, it immediately binds all classes of creditors and governs all provable claims that arose before the proposal's filing date. If the proposal is rejected by the creditors or the court, the debtor is automatically deemed bankrupt. The debtor may not seek protection under the CCAA.

Companies' Creditors Arrangement Act

Subject to certain exceptions, protection under the CCAA is available to an insolvent Canadian corporation if total claims against it exceed Cdn$5 million. Affiliated companies' debts may be included to meet the threshold.

To initiate proceedings under the CCAA, the debtor files a Notice of Application with the court. The Notice requests an order permitting the debtor to file a proposal for reorganization and grants a stay of proceedings. The initial stay usually lasts for 30 days. The CCAA provides the court with no guidelines

concerning the scope of the stay. To date, the CCAA's stay provision has been broadly interpreted. If the court grants a stay, it will appoint a monitor to supervise the debtor's business and financial affairs.

Like the BIA, the CCAA allows creditors to be classified. The creditors must meet and vote on the debtor's proposed plan of reorganization, which must be accepted by the same double majority of creditors that the BIA requires. If a plan is not approved by the creditors or the court, the debtor may not start proceedings under the proposal provisions of the BIA.

Although restructuring under the CCAA usually is more expensive and time-consuming than under the BIA, debtors use the CCAA more often because the court possesses greater discretion to deal with complex reorganizations.

Debtor-in-Possession Financing

Unlike the US, which specifically provides for secured financing of Chapter 11 debtors, Canada has no formal system to protect lenders prepared to finance a debtor-in-possession (DIP). However, DIP financings have been arranged under the CCAA in a number of cases. One must obtain a court order, which lies purely in the court's discretion in any case.

Bankruptcy

Bankruptcy proceedings under the BIA are analogous to Chapter 11 proceedings. Debtors become bankrupt in Canada in one of the following three ways:

- by filing a proposal for reorganization that is either refused by the creditors, or accepted by the creditors and rejected by the court (as discussed above);
- by making an assignment for the general benefit of the creditors (voluntary bankruptcy); or
- by being petitioned into bankruptcy by one or more of the creditors (involuntary bankruptcy).

Voluntary Bankruptcy

Debtors can make an assignment in bankruptcy only if they are "insolvent." Under the BIA, debtors are insolvent if:

- they cannot meet their obligations as they generally become due;
- they have stopped paying their current obligations in the ordinary course of business as they generally become due; or
- the value of their property is insufficient to satisfy their debts.

Involuntary Bankruptcy

A creditor can petition the debtor into bankruptcy if the debtor has committed an "act of bankruptcy," as defined in the BIA, within the six months preceding the petition. Most commonly, the petition is filed because the debtor has ceased to meet its liabilities generally as they become due. Should the debtor dispute the petition, the matter is referred to a judge for a hearing. The court has a wide discretion to:

- stay the petition, altogether or for a limited period of time;
- dismiss the petition; or
- enter a receiving order, declaring the debtor bankrupt. An under-secured creditor may consider petitioning the debtor into bankruptcy for strategic reasons. For example, priorities between a secured creditor and some statutory claimants (as discussed above) may improve if the debtor becomes bankrupt.

Effect of Bankruptcy

A bankruptcy stays the claims of all creditors, except secured creditors. A trustee-in-bankruptcy is appointed and all of the debtor's assets vest in the trustee. The assets are sold and the proceeds are distributed among the debtor's creditors, in accordance with priorities determined by the BIA. Secured creditors, however, generally are not affected by these proceedings and are entitled to exercise their rights over the collateral for which they have a security interest.

Potential Preference Claims

Security granted to an arm's length lender may be found void as a preference under the BIA. However, a preference is found only where the debtor granted the security within three months preceding the debtor's initial bankruptcy event.

Repossession of Goods by Suppliers

A lender who finances goods that a supplier provides to a debtor may be at risk if the debtor becomes bankrupt or insolvent within 30 days of receiving those goods. Under the BIA, unpaid suppliers may repossess their goods within a period of thirty days after delivery to the purchaser, in certain circumstances. However, if the purchaser resold the goods, or the goods cannot be identified, the rule does not apply. In Canada, the supplier's rights do not attach to the proceeds of sale, as they do in the US under American repossession rules.

A Cautionary Note

The foregoing provides an overview of selected Canadian legal issues in secured lending. Readers are cautioned against making any decisions based on this material alone. Rather, a qualified Canadian lawyer should be consulted.

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