secured lending in Canada

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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

Under the Bank Act (Canada), a "foreign bank" is not permitted to engage in or carry on business in Canada except as authorized by the Act (i.e. through a foreign bank subsidiary or an authorized foreign branch or some other approved entity). The term "foreign bank" is broadly defined in the Act to include any entity that is called a bank or that is regulated as or like a bank. It also includes any entity that controls a foreign bank and any entity that provides financial services and is affiliated with a foreign bank.

This prohibition against engaging in or carrying on business in Canada would not prohibit a foreign bank from making a loan to a Canadian borrower as long as the nature and extent of all the foreign bank's activities in Canada do not amount to engaging in or carrying on business in Canada. Whether a foreign bank would be considered to be engaging in or carrying on business in Canada by reason of making a particular loan to a Canadian borrower would depend on all the surrounding facts and circumstances. Some of the factors that could be relevant include: how the relationship between the foreign bank and the Canadian borrower arose; where the documentation was negotiated and executed; and where the transaction was closed. Generally, where all aspects of the marketing, negotiation, execution and closing of a loan transaction by a foreign bank take place outside Canada, the foreign bank would not be considered to be engaging in or carrying on business in Canada solely by reason of that loan transaction.

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 to establish a foreign bank subsidiary or to maintain 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

Conventional interest payments made to arm's length lenders that are non-residents of Canada are generally not subject to Canadian withholding tax, regardless of their country of residence. In addition, conventional interest payments made to certain non-arm's length US resident lenders may qualify for an exemption from Canadian withholding tax under the Canada-United States Income Tax Convention (1980), as amended.

In the absence of these or other applicable exemptions under treaties or under the Income Tax Act (Canada) (ITA), withholding tax on interest payments could apply at rates up to 25%.

thin capitalization rules

US lenders sometimes lend to a US parent corporation which, in turn, lends those funds to a Canadian subsidiary. Thin capitalization rules under the ITA determine whether the subsidiary may deduct interest on the amount borrowed from its US parent or from other non-residents not dealing at arm's length with the US parent (collectively "specified non-residents"). In general terms, the rules prevent Canadian subsidiaries from deducting interest on the portion of loans from a specified non-resident that exceeds one and one-half times the subsidiary's "specified equity" (in highly simplified terms, its retained earnings, share capital and contributed surplus attributable to specified non-residents). In addition, any interest expense that is disallowed under the thin-capitalization rules is deemed to be a dividend paid to the specified non-resident, potentially subject to withholding tax at rates up to 25%.

Similar rules apply to loans to partnerships in which a Canadian-resident corporation is a member. Furthermore, recent proposed amendments to the ITA will extend the thin-capitalization rules (with some modifications) to Canadian resident trusts and to non-resident corporations and trusts that carry on business in Canada (as well as partnerships that include such persons).

Where a US lender does not hold shares (or rights to acquire shares) in the Canadian subsidiary, and deals at arm's length with persons who do, the thin capitalization rules should generally not apply to a direct loan to the Canadian subsidiary.

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 (personal) or immovable (real) property. It may be made with or without delivery, allowing the grantor of the hypothec 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.

An 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. However, there is no clear code governing the relative priorities of competing Bank Act and PPSA security. For instance, Section 427 Security may lose priority to a security interest created and perfected under the PPSA, even if not registered, where a secured party retains legal title to an asset (e.g. conditional sale agreement).

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. Unlike the UCC, the PPSA does not recognize the concept of "control" as a means of perfecting a security interest in cash on deposit in a deposit account. A bank lender that operates deposit accounts for a debtor may wish to take cash collateral in such accounts by way of set off and a "flawed asset" approach, however in light of current Canadian case law, the lender should also ensure that it registers a PPSA financing statement against the debtor in respect of such arrangements.

lock-boxes and blocked accounts

Traditionally, 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 over the last 20 years, 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, most 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 and the Securities Transfer Act, 2006 (STA), versions of which are in force in most Canadian jurisdictions, a secured party can perfect its security interest in shares by registering under the PPSA or by taking control under the STA (or both). Quebec legislation in respect of the transfer of securities came into force on January 1, 2009 and harmonized Quebec legislation relating to the transfer of securities with the law applicable in most of other Canadian provinces and the US. An interest perfected by control is superior to one perfected only by registration. For certificated shares, taking physical possession of the share certificates (endorsed, if applicable) meets the STA requirement for control. Control in other forms of investment property such as book-based securities can be achieved by other means under the STA, such as a control agreement with the relevant intermediary. In Ontario, the practice is to perfect by both control 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, has become very common, especially in the case of time sensitive matters. 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. A court-appointed receiver or trustee in bankruptcy will typically be protected against pre-existing environmental liabilities under the Bankruptcy and Insolvency Act (see Page 7) so lenders may wish to consider these options where significant environmental liabilities are associated with their collateral.

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, fines, penalties, 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 intercorporate guarantees are quite different from their US counterparts. Generally speaking, the validity of an intercorporate guarantee is less likely to be successfully challenged under bankruptcy, fraudulent conveyance or preference legislation. In many jurisdictions in Canada,corporate laws 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. However, the corporate laws in a few Maritime provinces and in the territories continue to prohibit financial assistance to members of an intercompany group if there are reasonable grounds to believe that the corporation would be unable to meet prescribed solvency tests after giving the assistance, subject to specified exceptions. Under certain circumstances, granting a guarantee in a manner that disregards the interest of creditors or minority shareholders could be challenged under the 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 a bankruptcy of the debtor or a restructuring of the debtor under the BIA or CCAA (discussed in greater detail below).

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 secured lender in no way alters that obligation. However, as a practical matter, a junior lender is more likely to challenge the senior lender's actions than is the debtor or the unsecured creditors. Moreover, the junior lender possesses certain technical rights that may otherwise affect realization (for example, the junior lender is entitled to receive notice of and to object to a disposition or acceptance of collateral by the senior lender).

Finally, the junior lender might make it more difficult to successfully reorganize the debtor's financial affairs. For example, in restructuring proceedings under the CCAA and the BIA the debtor's creditors are divided into classes for the purposes of voting on the debtor's reorganization plan or proposal. Often the secured lender has the advantage of being in a class by itself, which gives the secured lender significant control over the process. In cases where there is senior and junior secured debt, the senior and junior lender may be placed in separate classes. Since a reorganization plan or proposal binds only the classes of creditor that approve it, this may result in the junior lender having an effective veto over the plan or proposal.

insolvency and restructuring

Canada's two principal insolvency statutes are the Bankruptcy and Insolvency Act (BIA) and the Companies' Creditors Arrangement Act (CCA A). In Canada, reorganizations analogous to a Chapter 11 proceeding can be conducted under the BIA through that statute's proposal regime or under the CCA A. Liquidations akin to Chapter 7 proceedings in the U.S. are conducted under the BIA.

corporate restructuring statutes

In Canada, reorganizations can be conducted under the BIA or, for a company or income trust with at least $5 million in debt, under the CCA A. Both acts provide a mechanism by which a debtor can obtain a stay from its creditors claims while the debtor attempts to reorganize its financial affairs through a proposal or plan to its creditors.

proposals under the Bankruptcy and Insolvency Act

The restructuring process under the BIA begins by filing either a definitive proposal for compromising claims of creditors or a notice of intention to make a proposal (NOI). Once the NOI or proposal is filed, all creditors' claims and proceedings against the debtor are stayed automatically. Subject to certain exceptions, secured creditors are stayed from enforcing their security unless they gave a notice of intention to enforce security more than ten days before the NOI or proposal was filed. Where the process is commenced with an NOI, the debtor must file a proposal within 30 days of the filing of the NOI, unless an extension is granted by the court. A debtor who fails to file a proposal within the time stipulated is automatically deemed to have made an assignment into bankruptcy.

A proposal under the BIA may be put to all creditors together, or to unsecured and secured creditors arranged in classes. If included, secured creditors with a "commonality of interest" must be in the same class. Although the proposal need not include all secured 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 unsecured creditors with provable claims that arose before the proposal's filing date as well as those included secured creditors in classes which voted in favour of the proposal. If the proposal is rejected by the creditors or the court, the debtor is automatically deemed to have made an assignment into bankruptcy.

Companies' Creditors Arrangement Act

Subject to certain exceptions, protection under the CCAA is available to an insolvent Canadian corporation which has assets or carries on business in Canada if total claims against the corporation exceed CDN$5 million. Affiliated companies' debts may be included to meet the threshold.

To initiate proceedings under the CCAA, an application is filed with the court. The application requests an order permitting the debtor to file a plan of compromise or arrangement and granting a stay of proceedings. The initial stay period cannot exceed 30 days. The CCAA provides the court with broad discretion concerning the scope of the stay. The CCAA's stay provision has been broadly interpreted. If the court grants a stay, it must also appoint a monitor to supervise the debtor's business and financial affairs.

Like the BIA, the CCAA allows creditors to be separated into different classes. 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.

Although restructuring under the CCAA is usually more expensive and time-consuming than under the BIA, larger corporate debtors tend to use the CCAA because there is greater flexibility to deal with complex reorganizations.

restructuring under the BIA and the CCAA

Among the restructuring powers available to a debtor under the BIA and the CCAA, some of the most notable include:

- debtor-in-possession financing: Courts have express authority to approve debtor-in-possession financing (DIP), subject to statutory guidelines.
- assignment and disclaimer of executory contracts: Debtors are authorized to assign (with court approval) or disclaim executory contracts, excluding collective bargaining agreements, financing agreements where the debtor company is the borrower, real property leases where the debtor is the lessor as well as derivatives and other "eligible financial contracts".
- asset sales: debtors are expressly authorized to pursue asset sales out of the ordinary course of business during a restructuring, including a going-concern sale of a business. The sale must be approved by the court, which is to consider a number of specific criteria, and notice of a sale must be given to secured creditors who are likely to be affected by the sale.
- cross-border proceedings: the debtor has the ability to coordinate its insolvency proceedings in multiple jurisdictions through a set of provisions drawn from elements of the UNCITRAL model law, which also formed the basis for Chapter 15 of the United States Bankruptcy Code.

In addition, the BIA and CCA A allow the possibility of avoidance litigation, which is common in US Chapter 11 proceedings. Trustees (under the BIA) and monitors (under the CCA A) are authorized to review and apply to court to set aside certain transactions entered into within prescribed periods prior to the filing where such transactions appear to be preferential or to constitute transfers of the debtor's property at conspicuously less than fair market value.

bankruptcy

Bankruptcy proceedings under the BIA are analogous to Chapter 7 proceedings. Debtors become bankrupt in Canada in one of the following three ways:

- by failing to file a proposal for reorganization after filing an NOI or 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 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 apply for a bankruptcy order in respect of a debtor who owes at least $1000 in unsecured debt and has committed an "act of bankruptcy," as defined in the BIA, within the six months preceding the application. Most commonly, the application is filed because the debtor has ceased to meet its liabilities generally as they become due. Should the debtor dispute the application, the matter is referred to a judge for a hearing. Where the facts alleged in the application have been proven, the court will enter a bankruptcy order, declaring the debtor bankrupt.

An under-secured creditor may apply for a bankruptcy order for strategic reasons. For example, priorities between a secured creditor and some statutory claimants (as discussed above) may be "reversed" in certain circumstances 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, are generally not affected by these proceedings and are entitled to exercise their rights over the collateral for which they have a security interest.

investigations

Bankruptcy proceedings are sometimes also used by a creditor when the creditor wishes to investigate a debtor's affairs. The trustee has a statutory right to obtain possession of the bankrupt's books and records, to examine under oath the officers of the bankrupt or any other person reasonably thought to have knowledge of the bankrupt's affairs, and to require such a person to produce any documents in his or her possession or power relating to the bankrupt, the bankrupt's dealings or property. These powers may be important if there are concerns that the debtor has attempted to conceal certain assets or to conceal the transfer of certain assets.

As noted above, trustees are empowered to review and apply to court to set aside certain transactions (preferences or transfers at undervalue) entered into within prescribed periods prior to the bankruptcy.

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 subject to receivership within 30 days of receiving those goods and has not paid for the goods. Under the BIA, unpaid suppliers may repossess goods delivered within 30 days before a bankruptcy or receivership if they make a demand for repossession within 15 days of the date of bankruptcy or receivership. The unpaid supplier's right to repossess the goods does not apply, if the debtor has altered the goods, resold the goods, or if the goods cannot be identified.

wage earner protection

Under the Wage Earner Protection Program Act (the WEPPA), an employee whose employer has become bankrupt or subject to receivership is entitled to receive payments from a federal Wage Earner Protection Program on account of any outstanding wages that were earned in the six months immediately prior to bankruptcy or the first day of receivership in an amount not to exceed the greater of $3,000 and four times the maximum weekly insurable earnings under the Employment Insurance Act.

Provisions of the BIA provide an employee of an employer which is bankrupt or in receivership, with a priority charge on the employer's "current assets" for unpaid wages and vacation pay (but not for severance or termination pay). This charge secures unpaid wages and vacation pay earned during the six month period prior to bankruptcy or receivership to a maximum of $2,000 per employee (plus up to $1,000 for expenses for "traveling salespersons"). The priority charge ranks ahead of all other claims, including secured claims, except unpaid supplier rights.

pension plan contributions lien

The BIA grants a priority charge in bankruptcies and receiverships for outstanding current service pension plan contributions, ranking behind the wage earners priority but otherwise with the same priority as is accorded to that lien. The pension contribution priority extends to all assets, not just current assets, and is unlimited in amount.

The pension charge secures (1) amounts deducted as pension contributions from employee wages but not contributed to the plan prior to a bankruptcy or receivership and (2) amounts required to be contributed by the employer to a pension plan, for "normal costs". The priority does not extend to unfunded deficits arising upon a wind-up of a defined benefit plan and should not include scheduled catch-up or special payments required to be made by an employer because of the existence of a solvency deficiency.

In its decision in Re Indalex, the Ontario Court of Appeal held that on the wind-up of a defined benefit pension plan, the statutory deemed trust imposed by the Ontario Pension Benefits Act (PBA) secures not only normal cost contributions but also any unfunded wind-up deficiency and/or past and future catch up or special payments. In some circumstances, the deemed trust provided for in the PBA ranks senior in priority to the interests of secured creditors in certain collateral. The priority is reversed on a bankruptcy of the employer.

The priority afforded to pension liabilities and unpaid employees in the BIA underscores the importance of effective reporting and monitoring of pension contributions by the borrower, as well as other employee obligations such as vacation pay.

The CCAA and proposal provisions of the BIA also contain provisions which protect employees in respect of wage and pension priority claims in a restructuring proceeding. The Court is expressly prohibited from sanctioning a proposal, compromise or arrangement or authorizing a sale of assets outside of the ordinary course, unless it is satisfied that the debtor has arranged to pay an amount equal to the amounts secured by the wage and pension priority charges (discussed above).

For a more detailed discussion of Canadian insolvency legislation and the amendments, please refer to McMillan's publications available at www.mcmillan.ca.

a cautionary note

The foregoing provides a summary of aspects of Canadian law that may interest investors considering doing business in Canada. A group of McMillan lawyers prepared this information, which is accurate at the time of writing. Readers are cautioned against making decisions based on this material alone. Rather, any proposal to do business in Canada should most definitely be discussed with qualified professional advisers.

(The information in this brochure is current to October 2013)