

Asset-Based Lending in Canada: An Overview for US Professionals

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This article was published by the Financial Services Group at Cassels Brock to keep our clients and friends informed of new and important legal issues. It is not intended to provide legal advice as individual situations will differ and should be discussed with a lawyer.

Introduction

As international trade grows, financial institutions recognize that international sales or globalization of their business is a requirement to staying competitive.

For many US-based companies, Canada is one of the first markets into which they will expand. The rationale for expanding into Canada is relatively simple in that there is geographical proximity, close historical ties, commonality of language (for the most part), interdependency in economy, and substantially similar electoral systems. Further, these two countries are the world's largest trading partners, and there is a relative ease of border crossing. It is for these reasons that Canada is often referred to as the "51st state."

The purpose of this paper is to highlight for an American financing professional, from a legal and business perspective, the issues that are encountered when entering or transacting business in the Canadian market, and how those issues differ from a typical US transaction.

No paper could be a complete compendium of all the issues and applicable laws or business practices in Canada. Further, it is not the purpose of this paper to discuss particular case law or the details of a particular statute. There are a number of short books prepared by law firms setting out many of the basic Canadian-law concerns in operating a business in Canada. Notably, our firm has published "Asset Based Lending in Canada" written by Alison Manzer and Howard Ruda, and *Doing Deals in Canada* available at <http://www.casselsbrock.com/files/file/docs/DoingDealsinCanada.pdf>. The authors of this paper will be pleased to forward copies of these books upon request.

This paper is focused on the commercial finance industry and will be split into two parts: the first dealing with the overall business environment in Canada and the second, dealing with legal issues. Our firm has written a similar paper focused on the equipment finance industry which can be found at <http://www.casselsbrock.com>.

1. Geo-Political Landscape

Canada is geographically large but thinly populated. More than 70% of Canadians live within 70 miles of the US border with the majority of Canadians living in Eastern Canada. The entire population of Canada is roughly the same as the population of California.

Many regions of Canada have similar personalities to regions of the US. British Columbia encompasses the West coast of Canada and the disposition of the people in this region is similar to that of California. Vancouver is the largest city in British Columbia and is often compared to San Francisco. The economy in British Columbia has a high degree of entrepreneurship and major tourism, forestry and fishing industries. Recently, large shale gas deposits were found in the region, which should cause significant economic growth. The province directly to the east of British Columbia is Alberta and it is often compared to Texas.

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Alberta has immense oil reserves and a reputation for entrepreneurship and conservative views. The oil sands project in Canada requires a significant amount of capital expenditure, including financing. The next two provinces east of Alberta are Saskatchewan and Manitoba. These provinces are compared to the Midwestern US states (Nebraska, Iowa). Currently Saskatchewan has large deposits of potash, oil and natural gas. Moving east to Central Canada the next province is Ontario, which is often considered the economic engine of Canada. Over 60% of goods produced for export are made in Ontario and it is the leader in both corporate head offices, technology industry and the auto industry. All of Canada's major bank and lessor head offices are located in Ontario and a significantly large percentage of the commercial financing industry is based in the province. The business community in Southern Ontario has been described as a cross between Chicago and New York.

Québec is unlike any American state. The province, which lies directly east of Ontario, has similar origins to Louisiana but the political and economic clout carried by Québec is significant. The majority of the province's residents speak French as their first or only language. The Québec economy includes hydro, aerospace and pulp and paper. Doing business in Canada for any period of time requires careful consideration and understanding of the requirements to service a portfolio in Québec.

The Atlantic Provinces (Nova Scotia, Prince Edward Island, New Brunswick, Newfoundland and Labrador) are usually compared to Maine. The Atlantic Provinces are an eclectic mix of economic activities and small populations. The aggregate population of the region is less than two million. However, recent off shore drilling operations and mining is causing significant growth in the region.

2. Canadian Legal System

In order to understand the mechanics behind transacting business and lending in Canada, it is necessary to have a basic understanding of the political and legal nature of the country.

Canada is divided into ten provinces and three territories. The rights and powers of the provincial or territorial governments, as well as those of the federal government, are derived from the Canadian constitutional documents that include the *British North America Act*. Generally speaking, the provincial or territorial governments set rules regarding property and civil rights, while the federal government sets policies for national issues.

Unlike the US, Canada has not adopted uniform business procedures and codes for the secured-lending business. The laws governing the lending industry tend to be provincial, as opposed to federal. The most important exception is insolvency law, which is a federal matter. Owing to this separation of powers between the federal and provincial governments, one must always be cognizant of where business is being transacted to ensure that the transaction is in compliance with the appropriate provincial laws. Although the

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lack of a unified code may seem daunting, many provinces have adopted substantially similar provisions with respect to particular matters. The exception to this rule, as will become apparent in this paper, is the province of Québec.

Canada's two founding nations were: Great Britain and France. In developing Canada's first constitution and separation of powers, the founding fathers were cognizant of the special role and requirements that French Canadians would have in Canada. Based on this premise, substantially different laws and procedures were established for Québec in comparison to the rest of Canada. For the purposes of this paper, any reference to the "rest of Canada," means all of the provinces and territories of Canada except Québec. Many of the comments set out in this paper will refer to the rest of Canada as opposed to Québec but, where appropriate, special commentary will be provided with respect to Québec issues.

It should also be noted that the writers are Ontario solicitors, and while every effort has been taken to ensure the accuracy of this paper, there is a strong bias toward Ontario concerns, and this paper may not fully reflect concerns in all provinces.

3. Cross-Border Financing Transactions

The easiest way to enter the Canadian market is to transact business from US headquarters as opposed to establishing operations in Canada. This strategy results in the lowest transaction costs and has the fewest legal ramifications, since US law would apply to a particular transaction with the exception of those areas which must be governed pursuant to local law. The most typical exceptions are the equivalent of the UCC's Article 9, being the *Personal Property Security Act*, and the UCC's Article 8, being the *Securities Transfer Act*. It is not possible to contract out of many provisions of these Acts therefore making specific knowledge of these laws essential when transacting business in Canada.

(a) Tax Considerations

Canadian Withholding Tax. Since January 1, 2008, interest paid by Canadian borrowers to US lenders is not subject to withholding tax if the parties deal at arm's length and the interest is not "participating." The tax changes that took effect in 2008 have opened up a new market for US lenders that was previously somewhat restricted given the added cost of withholding tax.

Canadian Mainstream Taxes. A US lender making a loan to a Canadian borrower will not be subject to Canadian mainstream tax if there is no Canadian connection other than the borrower being a Canadian resident. In this case, the loan should be originated through US sources, and neither the negotiation nor the closing should take place in Canada.

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If a US lender has a sales force located in Canada, it will generally be regarded as “carrying on business” in Canada and accordingly will be subject to mainstream Canadian tax. However, if the US lender is entitled to “treaty” protection and the US lender has not established a “permanent establishment” in Canada, the US lender will not pay Canadian mainstream tax. If a US lender has a permanent establishment in Canada (i.e., an office) and the US lender is entitled to “treaty” protection, the US lender would only be subject to tax on the profit attributable to the permanent establishment. If a US lender is subject to Canadian tax, then it may be entitled to certain tax credits in the US that attempt to limit taxation on the same income in both countries.

The rules relating to the definitions of “carrying on business” and “permanent establishment,” as well as the rules that determine the availability of treaty protection are quite complex and very fact driven and should be looked at with care if a US lender is planning to have any presence in Canada.

For the reasons above, it is typical for US lenders to first undertake transactions in Canada without carrying on business in Canada. As a US lender becomes more familiar with the Canadian market, it may consider establishing a Canadian subsidiary or Canadian branch operation.

(b) Corporate Structures

If it is determined that the most appropriate method of conducting operations in Canada is by establishing a corporation, then legal, tax, and other concerns must be considered.

The concerns most commonly raised include jurisdiction of incorporation and the structure of the corporation. A corporation may be incorporated under any provincial jurisdiction or under federal law. Generally, most companies that establish operations in Canada tend to choose to incorporate federally, but there is no compelling reason to do so.

The cost of incorporating and the corporate law statutes tends to be similar throughout the provinces, although the Canadian residency requirements of directors do vary and may be a determinative factor when selecting a jurisdiction to incorporate. Federal companies require that at least 25% of the directors are resident Canadians; provincial legislation in New Brunswick, Nova Scotia, and, most recently, British Columbia, have no residency requirements whatsoever. Canadian incorporation costs are about the same or lower than in the US and follow much of the same corporate logic.

The other major choice with respect to incorporation is the use of a vehicle known as an Unlimited Liability Company or “ULC.” The reason for utilizing this structure is that a ULC is viewed from a US-tax perspective as being able to take advantage of the check-the-box system. This allows a flow-through of profits and losses back to the US parent.

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However, amendments to the Treaty deny benefits to certain amounts paid by a ULC. A further advantage of the ULC is that there are no Canadian residency requirements for directors. On the other hand, the cost of setting up a ULC and the ongoing maintenance is greater than that of a traditional corporation. Therefore, in determining whether it is appropriate to use a ULC, a tax professional should be consulted especially with regard to the denial of Treaty benefits.

Currently in Canada, three provinces allow for ULC's, Alberta, British Columbia and Nova Scotia. Nova Scotia was the first province to provide for ULC's and as such is the most utilized jurisdiction. In the past number of years, the annual filing fees in Nova Scotia have risen substantially, making ULC's less economically attractive. In 2005, Alberta introduced legislation providing for ULC's and has established both the incorporation cost and annual fees to be substantially below that of Nova Scotia. There are certain technical reasons why a Nova Scotia ULC may be preferred, but many companies are utilizing Alberta ULC's. While Alberta requires that 25% of directors of a ULC be Canadian residents, Nova Scotia and British Columbia do not require any directors to be Canadian.

(c) Bank Regulation

Another significant issue that should be considered when establishing a lending operation in Canada is whether the operation would be regulated pursuant to the *Bank Act (Canada)*¹. Canadian law encourages foreign banks to establish operations in Canada and, in particular, to set up speciality operations. The *Bank Act* streamlines the process for a foreign entity to create a financing operation in Canada and to maintain a business. If a US lender is simply making loans to Canadian borrowers from the US without an establishment in Canada, then the operation will not be subject to regulation under the *Bank Act* and approval will not be required.

A lending operation will be subject to regulation under the *Bank Act* in Canada if the Canadian operation is associated (this term is used in a very broad sense) with a US regulated entity, such as a US bank. Being subject to regulation under the *Bank Act* will, in part, require approval from the Minister of Finance in Canada and will also limit what activities may be undertaken. If a finance company in the US is unregulated, then it is likely to be unregulated in Canada and no approval will be required.

To establish a lending operation in Canada that is regulated under the *Bank Act*, an approval to control a "financial establishment" from the Minister of Finance in Canada is required. These applications typically take two to six months to process and the cost is not significant. Although the approval is discretionary, most credible institutions are able to obtain this approval.

¹ S.C. 1991, c.46, as amended.

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It would also be prudent to determine whether specific provinces necessitate further requirements for lending institutions. Several provinces require lenders to be licensed in order to carry on business in the jurisdiction. For instance, in Saskatchewan, *The Trust and Loan Corporations Act, 1997*² requires that commercial finance lenders register (as a financing corporation) under the statute if the lending institution conducts business in the province. As well, if the advances are to consumers, then each province has its own consumer protection legislation that requires compliance. This paper focuses strictly on commercial as opposed to consumer transactions.

(d) Credit Agreements and Security Agreements

The good news for a US lender is that the basic security agreement utilized in Canada would be substantially similar to that used in the US. The process of amending US documents for use in Canada is often referred to as “Canadianization.” Generally speaking, this is accomplished without re-working substantial provisions of the US document but simply fine tuning certain provisions so that they can be applied in the Canadian environment. If the debtor has a presence or collateral in Québec, the security agreement will need to be further revised for use in that Province. Québec utilizes a document referred to as a hypothec in order to grant the equivalent of security interest. The hypothec is similar to the older style debentures in that both the amount of the advance (usually 20–25% above the loan amount to cover costs in the case of an insolvency) and a nominal interest rate (again higher than the actual interest rate) must be set out. While it is possible to have a single general security agreement that encompasses both Québec and the rest of Canada, most lenders have separate documentation for use in Québec.

In Canadianizing a US credit agreement, the most common changes made to a US credit and general security agreement are as follows:

(i) **Annualized Interest Rates.** In Canada, interest must be set out at an annualized rate. If interest is not set out at an annualized rate, it will be read down to 5%. Accordingly, if the interest rate is set out at 1.5% per month, this must be amended to 18% per annum. Also, all loans must set out the interest rate, otherwise, the rate will be deemed to be 5%.

(ii) **Usury Laws.** Canada has no usury statute *per se*, but overcharging for interest is governed by Section 347 of the *Criminal Code*³ which states that any requirement to charge interest over 60% is a criminal offence. It is unlikely that a traditional lending transaction will run afoul of this particular provision on its face. A credit agreement should contain

² Chapter T-22.2.

³ R.S.C. 1985, c.C-46.

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provisions to reduce the rate if it is held to be in excess of the criminal rate. Drafting the clause can be simple or complex depending on the nature of the agreement.

For the purpose of Section 347 of the *Criminal Code*, the Courts have defined interest broadly, including all charges and expenses associated with the loan (i.e., fees, fines, penalties, commissions, etc.). A lender must pay special attention, especially if the loan is short-term and there are high fees, as it may inadvertently violate these provisions. Canadian solicitors have long debated the impact of violating these provisions, and the results range from overturning the loan entirely to reading down the rate to 60%. Based on the facts of a particular transaction, a court is entitled to reduce the implied interest to the non-offending 60% without amending other aspects of the transaction demonstrating the equitable nature of Canadian courts as long as there is no criminal intent.

(iii) **Penalties.** The courts in Canada have established that provisions that are “penal” in nature are unenforceable. The law regarding what constitutes a “penalty” and thus renders an interest provision unenforceable is unclear in agreements where an additional payment above the pre-default interest rate is required upon default. There are numerous cases on this issue, but a consistent and defined result has yet to transpire. If the extra charge is seen simply as compensation for true administrative costs or compensation for increased risk, it is likely to be upheld. If, on the other hand, the charge is more punitive in nature, it would be viewed as an unenforceable penalty. Clearly, the greater the amount, the more likely it is to be considered a penalty. Most practitioners consider an increase of two percent to be reasonably safe, although it is not uncommon to see post default increases much higher.

(iv) **Funding Rates in Canada.** The floating reference rate in Canadian-dollar transactions analogous to LIBOR is based on the Canadian Dealer Offered Rate (“**CDOR**”). CDOR is the average banker acceptance rates from the principal Canadian financial institutions that are posted daily for all one-month, two-month, three-month, six-month and one-year bankers acceptances. Each of the Canadian banks publishes its “prime” rate as is the case in the US and it is common for agreements to reference the “prime rate” of a specified bank for floating rate loans.

(v) **Attorneys/Lawyers and Their Costs.** In Canadian documentation attorneys are referred to as “lawyers,” and the legal process for awarding costs in a trial differs from the US. In a Canadian lawsuit, typically, subject to the discretion of the Court, the loser is responsible to pay a portion of the winner’s costs – this is referred to as “cost following the event.” Costs are awarded on two different scales: either pursuant to a “partial indemnity costs” or a “substantial indemnity costs” basis. The former is lower than the latter and rarely does the costs award cover all costs incurred. Often, security agreements will be amended to incorporate these concepts. These concepts tend to make the parties less litigious. In relation to trial costs it should be noted that jury trials for commercial matters

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do not exist in Canada. A waiver of jury trial provision in a security agreement is meaningless except where litigation is brought outside Canada.

(vi) **Privacy Laws.** Canada has enacted privacy laws that prohibit the collection of personal information and distribution of such information to third parties without first obtaining the prior consent of the party who provided the information.⁴ These laws apply only to information acquired from individuals, as opposed to corporations. Accordingly, if the lending activity undertaken in Canada is strictly with corporations, local privacy laws do not apply. On the other hand, if there are consumer transactions or if the entities with whom the transactions are conducted are unincorporated, consent should be obtained. If a personal guarantee is given with respect to a corporation's security agreement, the guarantor's consent to release information should be obtained.

(vii) **Default Provisions.** There are no unique Canadian issues when determining what constitutes an event of default. However, in reviewing a security agreement, one must keep in mind that references to the *Bankruptcy Code* and the UCC must be changed to the *Bankruptcy and Insolvency Act* and the *Companies' Creditors Arrangement Act*. Expressions with respect to insolvency, liquidation and corporate re-organization have different meanings in Canada. If there are references to affiliate defaults or associate defaults, the governing statutes the parties utilize to define these matters will be based on Canadian-corporate statutes, which may cast a narrower or broader net than under the applicable American statute.

One should be cautious when relying on the "material adverse change" clause as an event of default. Canadian courts are reluctant to enforce a default provision if the only event that gave rise to a lender's right to enforce its security was a material adverse change. Since the credit crisis, there has been a renewed interest in drafting these clauses and they are becoming more specific than in the past.

(viii) **Currency Issues.** While there is no requirement that a loan agreement in Canada be denominated in Canadian dollars, a court in Canada will not enforce a judgement in a currency other than in Canadian dollars. Accordingly, if a financing is denominated in a currency other than Canadian dollars, it is prudent to provide a specific provision to assist the court in determining the applicable currency conversion which should be used in the event of an enforcement situation.

⁴ *Personal Information Protection and Electronic Documents Act*, S.C. 2000, c.5 ("PIPEDA").

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(e) Ancillary Documents

Following is a list of some points of interest relating ancillary documentation used in cross border loan transactions.

(i) **Blocked Account Arrangements.** A security interest in a bank account may only be perfected by registration of a financing statement in the province where the debtor's chief executive office is situated. While blocked account agreements, lock boxes and control agreements are sometimes used in Canada to obtain greater control over a borrower's cash flow, these arrangements will not assist the secured party with perfection. US loans are often approved subject to the condition that all obligors provide "full cash dominion" in order to ensure that the lender will have a perfected security interest in all bank accounts. Given that full cash dominion does not assist in perfection in Canada, the requirement for this condition should be considered by US lenders prior to approval in order to avoid a potentially needless expense.

(ii) **Pledges of Securities.** As at the date of writing, every Canadian province and territory, except Prince Edward Island and Yukon, have adopted a *Securities Transfer Act* based on the UCC's revised Article 8. The first legislation was enacted at the start of 2007. This legislation modernized Canadian commercial law rules governing the property rights that exist whenever securities are bought, sold or pledged as security. Unlike cash deposit accounts maintained at a Canadian bank, perfection of a security interest in a securities brokerage account may be perfected by either an account control agreement or the registration of a financing statement. An interest in a securities brokerage account perfected by way of control will prime an interest perfected by registration. Similarly, an interest in securities perfected by possession, will prime an interest perfected by registration.

(iii) **Execution and Filing of Financing Statement.** There is no requirement in Canada that (i) the debtor sign the financing statement (as there was under the old Article 9), (ii) a signed copy of the security agreement be filed with any government body, or (iii) a security agreement be signed prior to the registration of a financing statement. In Québec, a hypothec may not be registered unless it has been signed, and each agent completing a registration of a hypothec must certify that he or she has viewed the executed hypothec.

(iv) **Guarantees.** Most jurisdictions in Canada permit corporations to provide a guarantee to any person and on any basis. As a consequence, guarantees may be provided free of concerns regarding: preference, settlement, fraudulent conveyances or transfers. Some jurisdictions in Canada continue to maintain concepts of solvency tests for certain related parties at the time the guarantee is provided, but not on an ongoing basis. Accordingly, there is greater flexibility to provide guarantees in Canada than in the US.

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(f) Registration/Perfection

All provinces, except Québec, have a registration system similar to the UCC 9(R). In order to perfect a security interest that has been properly created by a signed security agreement, all that is required is the filing of a financing statement under the applicable legislation. The filing can be done electronically in all provinces. The rules governing perfection and priority issues in all provinces (except Québec) are conceptually similar to those under UCC 9(R).

The first province to enact a UCC-like system was the province of Ontario. *The Ontario Act* was utilized as a model for the legislation in other provinces. In all provinces (except Québec) there is a registration system governed by a *Personal Property Security Act*⁵ (“PPSA”). The following are some of the unique registration and perfection issues in Canada:

(i) **Jurisdiction of Registration.** The PPSA follows the rules that existed under the old UCC 9. The proper province in which to register a financing statement is the province where tangible personal property is located. Non tangible personal property is registered in the province where the chief executive office is situated. In determining the location of the chief executive office where there is more than one office, special care must be taken. Currently there are proposed amendments to conform the PPSAs across Canada with the UCC so that the debtor’s jurisdiction of formation is key for registration purposes. The PPSA in the province where the secured party is required to register also governs enforcement procedures and policies.

For mobile goods, the province in which the chief executive office of the debtor is situated is the appropriate province for registration. One oddity of the PPSAs is that they define “mobile goods,” as “goods that are normally used in more than one jurisdiction.” Accordingly, laptops and other semi-mobile goods can be problematic. Therefore the prudent course of action with respect to semi-mobile goods is to register both in the jurisdiction of the location of the collateral and the jurisdiction of the chief executive office of the debtor.

American attorneys may be particularly interested in determining where to register against a Canadian company who has assets in the US. Under the UCC 9(R), the appropriate location for filing would be in the jurisdiction where the chief executive office of the Canadian company is situated, if there exists a proper filing system in such jurisdiction. For all Canadian companies, this system does exist and, as such, the filing should occur in the applicable province. However, for tangible property, the proper place for filing under the PPSA is the jurisdiction where the tangible personal property is situated and accordingly, a filing in the US would be required. Since the Canadian company is not registered in the US,

⁵ R.S.O. 1990, c.P.10.

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the applicable jurisdiction for registration would require a filing in Washington, DC. For tangible personal property situated in the US, our advice is to register under the provincial legislation in Canada where the debtor's chief executive office is situated, the state where the tangible property is situated, and in Washington, DC.

(ii) **Debtor Name.** Much like the US, Canada has very specific rules regarding debtor names. For example, a failure to register the correct debtor name is fatal to a registration. While some provinces have enacted more liberal saving provisions than others, the general rule is that if the name is improperly set out on the financing statement and, as a result, would not be discovered by a search under the correct name, then the registration will be null and void.

What makes this particularly difficult is that the articles of many Canadian corporations provide for both an English name and a French name. Often, the individuals working for a company do not have knowledge of the French name of the company. For this reason, one should always undertake a corporate search to determine the complete and proper registered company name.

Another potential issue concerning the manner in which the name may be set out in the Articles of Incorporation of the company is when the name contains an English form and a French form. A corporation's name can either be completely separate or can have a slash between the English and French names. The prudent mechanism for registering a name would be to use the English name alone, then the French name alone, and lastly the combined name (sometimes in both forms). Some provinces do not require the registration of the French name at all. For instance, the province of Alberta, which is an Anglophone province, does not require the registration of a French name unless that is the only name by which the entity is known. Ontario and New Brunswick, on the other hand, require the registration of both names.

(iii) **Collateral Description.** Under the Ontario PPSA system, there are boxes to check to identify the type of collateral that is being financed. The types of collateral are "consumer goods," "accounts," "inventory," "equipment" and "other," as well as a box to indicate whether motor vehicles are included. While Ontario does not require a collateral description, it does require that the correct boxes are checked.

If you are financing inventory and you check only the box marked "equipment," the registration would be invalid. In addition, many parties check the box marked "other" to cover the proceeds from the sale. This is an incorrect (but common) procedure. The problem with checking an incorrect box is that you may receive requests for subordinations or waivers from parties owing to their desire to ensure that there is no security interest in property that they intend to finance.

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While there is no requirement to provide a collateral description in Ontario, there is an opportunity to do so in a box called “general collateral description” and such a description will limit the scope of the security interest. Where a secured party’s interest is limited and the secured party does not wish to receive subordination requests from other parties, it can list the assets, and thus limit the security interest specifically to the assets listed.

A secured party is required to provide collateral description wording in all provinces other than Ontario. For a security interest covering all property, most practitioners use the following collateral description: “All present and after acquired personal property of the debtor.”

(iv) **Assignment of Accounts Receivable.** In all provincial PPSAs, there is a requirement to register a financing statement for an absolute assignment of accounts receivable, whether or not such assignment creates a security interest.

For example, if Buyer Bank is purchasing a portfolio from Seller Bank regarding Debtor X, then Buyer Bank is required to register a financing statement against Seller Bank. If Buyer Bank fails to register its financing statement against Seller Bank and Seller Bank was to become insolvent, any amounts owing from Debtor X to Buyer Bank, pursuant to the assignment, would be subordinate to a trustee in bankruptcy of Seller Bank. While this result may be counterintuitive, it is a critical consideration when purchasing a portfolio. This rule is often missed in factoring financing where there is a true sale of the receivable and no back up security interest is provided. The purchaser of a receivable must register against the vendor and a failure to do so will render the sale opposable by a trustee in bankruptcy.

Under Canadian federal legislation, receivables owed by the federal government cannot be assigned as security unless appropriate notice is given to the government and the government consents to such a transaction. Some provinces have similar legislation covering receivables owed by the provincial government. It is recommended that US asset based lenders either exclude government receivables from the borrowing base or apply additional conditions to them if included in the asset base.

As in the US, anti-assignment clauses are generally ineffective to prevent the assignment of receivables in Canada. Third party financiers can safely advance money on the security of a contract with an anti-assignment clause.

(v) **Purchase-Money Security Interest.** Much like under UCC 9(R), a creditor can obtain super-priority status if all the appropriate steps are followed to obtain a purchase-money security interest (“**PMSI**”). There is potential for conflict between an inventory financier and a receivable financier where the former obtains a PMSI in inventory. The inventory financier’s PMSI can defeat a first ranking receivable financier’s interest because the PMSI extends to proceeds of the inventory, which includes receivables. If the same entity finances both inventory and receivables, this conflict may not arise.

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Like the US, the Western provinces have addressed this situation by giving receivable financiers an express priority in such a situation. In Ontario and the Atlantic provinces, financiers who hold a PMSI in inventory must give notice of their PMSI to anyone claiming an interest in accounts. Although this does not avoid a potential priority problem, it notifies the receivable financier of its exposed position. It is advised that a lender securing an interest in receivables insert a mechanism in its security agreement which allows for an appropriate course of action to be taken once these notices are received.

(g) Enforcement

Canadian insolvency law is both federally and provincially governed. The rules governing secured creditors and enforcement rights, absent a bankruptcy, are governed by the applicable PPSA, whereas bankruptcy is governed by federal law.

(i) **PPSA Enforcement.** In non-bankruptcy situations, the secured party will realize upon its collateral and will have an option to either sell the collateral to third parties or foreclose on the collateral. In either case, the secured party must send a notice to all third parties who may claim an interest in the collateral, including parties with a prior claim, a subsequent claim, and any guarantors. This notice will set out that these parties have a right to redeem the collateral upon the payment of the outstanding obligations. If no party chooses to redeem the collateral within the periods of time specified under the applicable PPSA (15 days in the province of Ontario), then the secured party is entitled to sell the collateral pursuant to reasonable procedures to a third party and apply the proceeds from the sale to the indebtedness. Any surplus is paid to the debtor, and the secured party can claim any deficiency as an unsecured creditor. This notice provision is particularly important to asset based lenders, as these lenders frequently hold a subordinated priority position. As a result, these lenders possess rights, such as the right to notice, that may affect realization.

If a secured party were to use the foreclosure procedure, the secured party would likewise have to send out notices, although in a different form, and the waiting period is slightly longer. In these circumstances, the secured party would retain all of the proceeds from the sale with no requirement to account to the debtor; however, the secured creditor is unable to claim the deficiency against the debtor for the unsecured portion of its claim.

It should be noted that in the processes set out above, there is no requirement to make an application to the court with respect to either the seizure or sale of the collateral; it is only necessary to follow the procedures set out in the PPSA. In fact, in Canada, the concept of “smash and grab” still exists provided that the debtor allows the secured creditor onto its property to seize the goods.

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(ii) **Bankruptcy.** In Canada, there are two basic bankruptcy statutes: the *Bankruptcy and Insolvency Act*⁶ (“**BIA**”) and the *Companies Creditors Arrangement Act*⁷ (“**CCAA**”). The CCAA involves larger insolvencies, while the BIA is used for smaller insolvencies or in cases of liquidation.

Under the BIA, the debtor may file a “Notice of Intention” whereby it advises each of its creditors that it intends to file a proposal under the BIA and initiates a stay of proceedings against the debtor. This proposal will set out a proposed settlement with each of its creditors. The proposal will be accepted if it is accepted by two-thirds in dollar amount and 50% in number of each of the classes of creditors. From the date of filing the Notice of Intention to the date that the proposal is either accepted or rejected by the creditors, all creditors are stayed from taking further action against the debtor. The debtor is required to file a proposal within 30 days of the date of its filing the Notice of Intention but can ask for time extensions up to a combined period of approximately seven months. Generally speaking, courts allow the time period to file a proposal to be extended by 60 to 90 days prior to entertaining creditors’ arguments that the stay be lifted. If, on the other hand, it can be shown that creditors will not support the proposal then the court would be more likely to lift the stay at an earlier time period. For a debtor, the advantage of the BIA as compared to the CCAA is that it is a relatively inexpensive process and can be accomplished quickly.

The CCAA process is governed strictly by the court. This regime allows for greater creativity than the process under the BIA. Courts have been known to allow stay periods under the CCAA to extend well beyond the seven-month limit imposed under the BIA and can compromise a variety of creditor claims in ways not permitted under the BIA. Similar to a US Chapter 11 filing, a creditor with a security interest in inventory may be a detrimentally affected by these rules particularly if the liquidation value of the inventory will decrease quickly over time.

Conclusion

Canada is substantially similar to the US in lending transactions therefore providing easy expansion into new markets. The business logic in determining courses of conduct is essentially the same. However, there are some differences, both culturally and legally, that must be taken into consideration.

⁶ R.S.C. 1985, c.B-3.

⁷ R.S.C. 1985, c.C-36.