

## CROSS-BORDER FACTORING Q & A

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When first asked to purchase receivables from a Canadian client, a U.S. factor is bound to have a number of questions. Can I use my forms? How do I perfect? What about Canadian taxes? Can I use the Canadian courts? What licenses will I need? And, more generally, what should I be concerned about when buying Canadian receivables?

The purpose of this paper is to answer these questions, and to provide a general overview of the issues that a U.S. factor should consider when purchasing Canadian accounts receivable.

**Documentation?** The good news is that material changes are rarely required when adapting a U.S. factor's documents to purchase Canadian receivables or take security on Canadian collateral.

Experienced Canadian counsel will often tighten up "sale" language in a factoring agreement to improve the likelihood that a Canadian court would respect the transaction as a sale rather than re-characterize it as a disguised loan.

Some adjustments are also desirable to reflect differences in Canadian legislation and procedures. For example, provisions that deal with the consequences of the seller becoming subject to the Bankruptcy Code should refer to the relevant Canadian bankruptcy and insolvency legislation, and since Canada has not adopted the ACH system, the factor should be given the general ability to debit its client's bank accounts by way of electronic transfers. Clauses should be added to the factor's standard forms to take into account the various issues described in the balance of this paper. All in all, neither factor nor seller should find that any of these changes raise significant business issues.

**Licensing?** It is important to appreciate the difference between (i) carrying on business in Canada on the one hand and (ii) doing business with Canadians on the other. So long as a U.S. factor and its agents do not carry on business on Canadian soil, but only deal with Canadian sellers and account debtors on a cross-border basis - such as by telephone and email - the factor will not be "carrying on business in Canada" and will not be required to be licensed under Canadian regulatory legislation. This is of particular importance to U.S. banks since they are prohibited from carrying on business in Canada without complying with the licensing requirements of the Canadian *Bank Act*. Canadian regulatory authorities recognize that a non-Canadian company can purchase Canadian receivables, lend to Canadian borrowers and take security over Canadian assets without becoming subject to Canadian licensing requirements, unless they "step over the line" and begin carrying on business in Canada.

Various activities that take place in Canada will usually not raise a licensing issue (e.g. meeting with a prospective client), while others will be more problematic (e.g. negotiating or signing an agreement). Issues of this nature arise on a regular basis and counsel should be able to provide practical advice.

**Canadian Taxation?** Similarly, a U.S. factor will not become subject to Canadian taxation on income it earns from purchasing Canadian receivables so long as the factor does not “carry on business in Canada”. Simply purchasing Canadian receivables, or opening a Canadian bank account, will not in and of itself result in carrying on business in Canada. As with licensing, the factor should not negotiate or sign business agreements in Canada. It is also important to ensure that the factor does not have any employees or agents in Canada, since their activities will be attributed to the factor. For this reason, if a factor engages a Canadian to provide leads to possible clients, the underlying agreement should clearly reflect that the Canadian is an independent contractor who has no ability to bind or contract for the factor, and that the parties have neither a principal/agent nor an employer/employee relationship.

**Withholding Tax?** Canada has virtually eliminated withholding tax on most cross-border payments of interest between unrelated parties that act at arm’s length. U.S. factors can therefore purchase the interest and finance charge components of Canadian receivables. Various other cross-border payments remain subject to Canadian withholding tax, such as rent, dividends and certain royalties.

**Perfection?** Every province and territory of Canada, other than Quebec, has personal property security legislation that is modelled after Article 9 of the U.S. Uniform Commercial Code. Accordingly, the rules relating to perfection, priority and enforcement of purchases and security interests are similar to those found in the U.S. While the two countries’ rules are not identical – such as the need to search and file in Canada based on the law of the jurisdiction where the debtor has its chief executive office, rather than where it is “registered” – any differences should not cause the U.S. factor any practical problems.

**Priority?** The Canadian Federal government has a super-priority lien over the entirety of a tax payer’s property for (i) certain amounts it withholds from its employees’ income but does not remit to taxing authorities and (ii) unremitted sales tax. This lien is not required to be registered. Factors should monitor compliance with these tax obligations - either with the client or the tax authorities – since the lien will generally rank ahead of the factors’ security interest on the client’s assets (but not on receivables that the factor actually purchase without notice of the lien).

**Guarantees?** It is generally easier in Canada to obtain an enforceable guarantee from a corporate affiliate – the guarantor’s incorporating statute and articles should be reviewed but will rarely raise an issue. With respect to individual guarantors who reside in Alberta, their guarantees will be valid only if they complete a statutory form in the presence of a notary.

**Quebec?** Quebec’s laws are modelled after the Civil Code of France, and differ significantly from those of the U.S. and the rest of Canada. Perhaps the four most important distinctions for a U.S. factor are: (i) perfection of a purchase of single receivables is achieved through notice to the account debtor rather than by registration, (ii) security over the client’s other assets is created by a “hypothec” under special language that should be added to the factoring agreement, (iii) agreements with a Quebec counterparty must be in French if they are “pre-determined” by the factor rather

than being open for review and negotiation by the seller and (iv) contracts with Quebec account debtors should be reviewed for provisions that prohibit assignment since Quebec has not enacted legislation to negate the effect of such provisions.

**Usury?** U.S. factors are often surprised to learn that Canada's federal usury legislation is set at the relatively high rate of 60%. In determining whether a usurious rate has been provided for or collected, all charges and expenses will be taken into account, including interest, fees, commissions, costs and various administrative payments. While no Canadian case has yet considered whether the legislation applies to factoring transactions, it is prudent to assume that it may. A properly drafted agreement should exclude the application of this legislation (although this may not be effective) and, as an alternative, provide that any contravention is unintended and that excess payments will be reimbursed or applied to other outstanding obligations.

**Interest?** Canadian legislation requires that interest be expressed at an "annual" rate (e.g. 12% per annum rather than 1% per month). If the provisions of a factoring agreement calculate interest on another basis – such as using a 360 day year – it is common to add a formula that permits calculation of the equivalent annual rate.

**Currency?** A U.S. factor that purchases Canadian receivables should consider how it will deal with the currency risk inherent in using U.S. dollars to acquire the Canadian funds it requires to purchase Canadian dollar receivables – since it is likely that the exchange rate prevailing when the factor obtains the Canadian funds will change by the time it receives Canadian dollars from the account debtor. Among the approaches factors have chosen: (i) entering into a currency hedge, (ii) passing any exchange losses to the client and (iii) depositing a significant amount of Canadian dollars in a Canadian bank account and using the account to purchase receivables and receive payments on the receivables (so that exchange losses and gains don't arise every time a receivable is collected, but only when funds are eventually repatriated to the U.S.).

Canadian courts must render judgments in Canadian dollars only. This may result in a currency exchange loss if (i) a factor sues for amounts owing in another currency, such as U.S. dollars, (ii) it obtains judgment for the equivalent Canadian dollar amount and (iii) the Canadian dollar strengthens between the time of judgment and the time of payment. The factoring agreement should therefore contain a provision that expressly requires the client to indemnify the factor for such losses.

**Canadian Courts?** A U.S. factor is generally able to bring legal proceedings in Canada. It will also find Canadian courts relatively creditor friendly for a number of reasons: (i) court costs are determined on the English "loser-pay" model, under which the unsuccessful party must pay a portion of the prevailing party's legal costs, (ii) commercial matters are almost always decided by a judge without a jury (whether or not the parties' agreement contains a jury waiver), (iii) punitive damages are extremely rare and (iv) U.S. judgments are generally enforceable in a Canadian court so long as the defendant was given proper notice of the action and an opportunity to defend.

**Government Obligations?** The obligations of certain Canadian governments – such as the Province of Ontario – are freely assignable. However, the Federal Government

and certain provinces have enacted legislation that prohibits the sale or pledge of their receivables without consent.

**Conclusion?** U.S. factors have found that the Canadian legal, tax and regulatory rules are relatively favourable, and don't impede the cross-border factoring of Canadian receivables.