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INTRODUCTION

As international trade grows, financial institutions and manufacturers of equipment 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”.

This paper is written from the perspective of a knowledgeable US-financing professional and the concerns that such a professional would have in either doing cross-border transactions or in transacting a direct Canadian business. Simply stated, the purpose of this paper is to highlight for an American professional, from a legal and business perspective, the issues that he or she would face in entering or transacting business in the Canadian market and how those differ from what one would normally expect in a US transaction.

It should be recognized that no paper could be a complete compendium of all the various issues and applicable or relevant laws or business practices in Canada. Further, it is not the purpose of this paper to discuss particular case law or meanings of a particular statute. Our firm has prepared a short book, which sets out many of the basic Canadian-law concerns in operating a business in Canada. The authors will be pleased to forward copies of these books upon request. This paper will be split into two parts, the first dealing with the overall business environment in Canada (e.g., size of market, types of leasing, geographical issues) and the second, dealing with legal issues.
PART 1 — BUSINESS ENVIRONMENT

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

Many regions of Canada have similar personalities to regions of the US British Columbia (“B.C.”) encompasses the West coast of Canada and the attitude of this region is similar to California. British Columbia is the home province of the City of Vancouver which is often compared to San Francisco. The B.C. economy has a high degree of entrepreneurship and major tourism, forestry, mining and fishing industries. The province east of British Columbia is Alberta and it is often compared to Texas. Alberta has huge oil reserves and a reputation for entrepreneurship and conservative views. Currently, the oil sands industry in Canada is driving large equipment purchases. The Provinces of Saskatchewan and Manitoba are compared to the Midwestern US states (Nebraska, Iowa). Ontario is often called the economic engine of Canada. Over 60% of goods produced for export are made in Ontario. The business community in Southern Ontario has been described as a cross between Chicago and New York.

Quebec is unlike any American state. The province has similar origins to Louisiana but the political and economic clout carried by Quebec is significant. The province has a majority of residents who speak French as their first or only language. The Quebec economy includes hydro, aerospace, mining and pulp and paper. Canadian equipment lessors report that 30% of their leased assets are located in Quebec. Doing business in Canada for any period of time requires careful consideration and understanding of the requirements to service a portfolio in Quebec.

The Eastern Most Provinces (Nova Scotia, Prince Edward Island, New Brunswick, Newfoundland and Labrador) are usually compared to Maine. The Maritimes is an eclectic mix of economic activities with a small population (approximately 2 Million).

SIZE OF CANADIAN MARKET

The estimated size of lease assets under management by Canadian leasing companies is $103 billion. Equipment finance companies make up $48 billion of this total. The majority of lessees (60%) are Small and Medium sized Enterprises (“SMEs”). Annual volume of commercial equipment finance was estimated to be $19 billion in 2004. These estimates are based on a survey of members of the Canadian Finance and Leasing Association (“CFLA”). Since
the membership does not reflect all of the industry participants it is accepted that the estimates are under stated.

The Canadian leasing market is made up of domestic and international bank owned lessors, large independents and captives, and a large group of small lessors. The CFLA is made up of the majority equipment and vehicle lessors that do business in Canada. There are roughly 150 leasing company members but 20 of the members fund 95% of the leasing business written in Canada. The 20 largest lessors include global players such as GE Capital, CIT, Bank of America, PNC Equipment Finance, Caterpillar Financial Services Inc., Wells Fargo, IBM Financial and John Deere Credit. The smaller private leasing companies are independents, many with very small portfolios.

According to the CFLA 2005 Update, in spite of economic and geo-political shocks including the War on Terrorism, SARS and the appreciation of the Canadian dollar, the Canadian leasing market has enjoyed a rebound after a few years of declining activity. A modest recovery in machinery and equipment investment has raised business demands in Canada for equipment financing. Further, the leasing market in Canada is mature – leasing is an accepted financial alternative for equipment and vehicle purchases and the improvement in the investment climate is a significant development for the industry.
## DISTRIBUTION OF REPORTED EQUIPMENT ASSETS BY TYPE  
(EXCLUDES INDEPENDENT & MANUFACTURE VEHICLE LESSORS)

<table>
<thead>
<tr>
<th>Rank</th>
<th>Equipment Type</th>
<th>2003</th>
<th>2004</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Automotive Total</td>
<td>27%</td>
<td>25%</td>
</tr>
<tr>
<td></td>
<td>Trucks</td>
<td>14%</td>
<td>13%</td>
</tr>
<tr>
<td></td>
<td>Trailer</td>
<td>11%</td>
<td>11%</td>
</tr>
<tr>
<td></td>
<td>Buses</td>
<td>2%</td>
<td>2%</td>
</tr>
<tr>
<td></td>
<td>Passenger</td>
<td>0%</td>
<td>0%</td>
</tr>
<tr>
<td>2</td>
<td>Construction</td>
<td>12%</td>
<td>13%</td>
</tr>
<tr>
<td>3</td>
<td>Manufacturing and Processing</td>
<td>9%</td>
<td>9%</td>
</tr>
<tr>
<td>4</td>
<td>Aircraft and Related</td>
<td>7%</td>
<td>7%</td>
</tr>
<tr>
<td>5</td>
<td>Office Equipment</td>
<td>6%</td>
<td>6%</td>
</tr>
<tr>
<td>6</td>
<td>Computers (Hardware and Software)</td>
<td>6%</td>
<td>5%</td>
</tr>
<tr>
<td>7</td>
<td>Medical, Health Services</td>
<td>3%</td>
<td>3%</td>
</tr>
<tr>
<td>8</td>
<td>Forestry</td>
<td>3%</td>
<td>3%</td>
</tr>
<tr>
<td>9</td>
<td>Mining and Petroleum</td>
<td>3%</td>
<td>3%</td>
</tr>
<tr>
<td>10</td>
<td>Materials Handling</td>
<td>2%</td>
<td>2%</td>
</tr>
<tr>
<td>11</td>
<td>Office Furniture and Fixtures</td>
<td>1%</td>
<td>1%</td>
</tr>
<tr>
<td>12</td>
<td>Store Furniture, Fixtures, Equipment</td>
<td>1%</td>
<td>1%</td>
</tr>
<tr>
<td>13</td>
<td>Railway Rolling Stock</td>
<td>1%</td>
<td>1%</td>
</tr>
<tr>
<td>14</td>
<td>Agriculture</td>
<td>1%</td>
<td>1%</td>
</tr>
<tr>
<td>15</td>
<td>Telecommunications</td>
<td>0%</td>
<td>0%</td>
</tr>
<tr>
<td>16</td>
<td>Water Vessels</td>
<td>0%</td>
<td>0%</td>
</tr>
<tr>
<td>17</td>
<td>Hotels, Restaurants, Apartments</td>
<td>0%</td>
<td>0%</td>
</tr>
<tr>
<td></td>
<td>Other</td>
<td>17%</td>
<td>18%</td>
</tr>
</tbody>
</table>

The marketing methods to originate leases in Canada mirror those of American lessors. In the smaller ticket leasing business the volume is driven from vendors and vendor programs. The mid and large ticket lessors focus more on direct lessee solicitation. Due to the small size of the overall Canadian market there is less specialization of a lessor in specific equipment markets.

The Canadian market for leasing is strong with good growth prospects. The industry has heightened awareness with government and has a much more positive image with policy makers. There is still enormous potential for leasing to gain further market share in the SME’s market. This market continues to be underserved by the traditional lending community.
PART 2 — THE LEGAL ENVIRONMENT

OVERVIEW OF THE CANADIAN GEOPOLITICAL ENVIRONMENT

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

While Canada is substantially similar to the United States, it does have a different political history, more akin to the British model as opposed to the US or French model. Although there is a common British heritage with both Canada and the US, until very recently, Canada did not become fully independent from the United Kingdom. Until the late 1940’s, it was still possible to appeal decisions from the Supreme Court of Canada to the Privy Council in the United Kingdom. Indeed, the Queen is still officially Canada’s Head of State. This difference in history has caused anomalies which US professionals must be aware of in communicating concepts and understanding policies.

As noted above, 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 papers that include the Constitution Act, 1867 (formerly called the British North America Act, 1867). 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 leasing 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 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 particularly apparent in this paper, is the province of Quebec.

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, substantially different laws and procedures were established for Quebec in comparison to the rest of Canada. For the purposes of this paper, any reference to “ROC”, which stands for the “rest of Canada”, means all of the provinces and territories of Canada except Quebec. Many of the comments set out in this paper will refer to ROC as opposed to

Quebec but, where appropriate, special commentary will be provided with respect to Quebec issues.

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

CROSS-BORDER TRANSACTIONS

The easiest way to enter the Canadian market would be to transact business from the US headquarters and not to establish operations in Canada. This strategy would result in the lowest transaction costs and have the least legal ramifications, as 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 exception is the ROC’s equivalent of the Uniform Commercial Code’s (the “UCC”) Article 9, being the Personal Property Security Act (the “PPSA”), personal property security legislation across the provinces. Many provisions of the PPSA cannot be contracted out of, and knowledge of this law is essential. As will be discussed below, the PPSA is modeled on the UCC’s Article 9.

a) 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.

The above noted rule regarding withholding tax does not extend to true or finance leases. It also must be emphasized that in determining whether a transaction is a lease or a loan the form and not the substance of the transaction is determinative. If the transaction is called a lease and there is a nominal purchase option it is a lease for withholding tax purposes. Simply stated, if a US lessor leases equipment to a Canadian lessee, the Canadian lessee is required to withhold and pay 10% of the lease payment to the applicable Canadian government taxing authorities. (This is not just on the interest component, but on the entire lease payment.) Accordingly, if a lease payment were to be $1,000, the Canadian lessee would be required to withhold $100 from the payment and remit to the US lessor the remaining $900. Clearly, from an economic standpoint, this is not an acceptable solution.
The most common method of resolving this withholding tax issue is to require the Canadian lessee to increase the payment that would otherwise be payable by the lessee, such that the amount received by the US lessor would be its anticipated payment. This is called a “gross-up provision”. In a sophisticated or negotiated transaction, generally, the gross-up provision has a requirement that if the US lender/lessor was able to file appropriate papers and recover some of the tax paid on its behalf by the Canadian lessee, then such amount would be returned to the Canadian lessee. Practically speaking, however, many US companies are not in a position to benefit from these foreign tax credits and, as such, the money is lost from the cycle. Needless to say, requiring a gross-up in a transaction tends to make the US-based leasing company less competitive in the Canadian market as other parties can provide a financial solution at a much lower cost.

b) Exceptions to Withholding Tax

There are a few exceptions to the withholding-tax rules, and these are the ones that tend to be utilized in most structured cross-border deals.

i) Aircraft Exemption.

One notable exemption to the withholding tax on lease transactions are aircrafts. The *Income Tax Act* (Canada)\(^2\) historically exempted aircrafts from withholding tax as it was difficult for Canadian airlines to attract sufficient capital for the lease of large commercial aircrafts. This exemption remained in the *Income Tax Act* (Canada) after the changes to withholding tax in 2008. It should be noted, however, if a US lessor enters into a lease with a Canadian lessee, then the lessor will not be able to provide the lessee with a Section 16.1 election under the *Income Tax Act* (Canada), which as will be discussed later in this paper provides the Canadian lessee with the equivalent of a synthetic lease.

ii) Assignment to Canadian Partner.

The classic way of avoiding withholding tax is to assign the transaction to a Canadian entity. The sale of the transaction does not attract withholding tax, and the originating institution could realize its profit from the transaction. The concern with this solution is two-fold. First, there must be a Canadian entity that wishes to purchase the transaction, and credit approval must be obtained, usually in advance. The second issue is that the originating institution will be exposing its client to a Canadian

\(^2\) R.S.C. 1985 (5\(^{th}\) Supp.), c.1
competitor because these transactions must be on a full-notification basis with respect to the assignment.

iii) Establishing a Canadian Entity.

The most common method of avoiding withholding tax is to establish a Canadian entity. It is trite to say that there is no withholding tax when a Canadian lessee pays a Canadian lessor. If the Canadian lessor is owned or controlled by a foreign entity then there may be tax concerns on the repatriation of the profits of the Canadian entity back to the US entity, but the fundamental lease transaction between the Canadian lessor and the Canadian lessee remains free from those particular issues. It is for this reason that most finance companies, when determining the most appropriate strategy for conducting Canadian business, choose a Canadian subsidiary.

c) Canadian Mainstream Taxes Cross Border Loan between a US Lender and Canadian Borrower.

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.

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.
**d) Quasi – Securitization**

A variant on establishing a Canadian subsidiary in entering the Canadian market is for a US lender to securitize an existing Canadian portfolio through a cross border loan. If a US finance company desires to have Canadian exposure to a lease or group of leases and they have been originated by a Canadian lessor, then the US bank can develop a loan structure which would accomplish this goal. The US financial institution would lend to the Canadian leasing company and take a first ranking security interest in the lease or pool of leases and enter into specific administrative procedures, such as blocked accounts to cause the lease payment to be paid to the US financial institution. In essence, this would be a non-recourse loan to the Canadian leasing company or special purpose entity which could be bankruptcy remote. Needless to say this over simplifies the various concerns that arise in these structures (such as insolvency and inter-creditor) but is a bare bones sketch of a possible funding option.

**ESTABLISHING OPERATIONS IN CANADA**

If it is determined that the most appropriate method of conducting operations in Canada is by establishing a corporation or other legal entity, 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 (“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. However, amendments to the Convention between Canada and the United States of America with respect to taxes on income and on capital (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 permit 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.

**BANK ACT**

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)*\(^3\). 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.

\(^3\) S.C. 1991, c.46, as amended.
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* 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.

One of the most significant concerns for US lessors who establish Canadian regulated operations in Canada are the residual restriction. In essence, a Canadian regulated financial institution cannot take a residual on any one transaction of more than 25% and on a portfolio bases of not more than 10%. The other significant restriction is that Canadian banks cannot lease cars or light trucks. Again, these rules are complicated and the above merely highlights the concern.

**LEASING CONCERNS**

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 Quebec, the security agreement will need to be further revised for use in that Province. Quebec utilizes a document referred to as a hypothec in order to grant the equivalent of a 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 Quebec and the rest of Canada, most lenders have separate documentation for use in Quebec.

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

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4 Chapter T-22.2.
1. Interest and Penalties.

There are three basic concerns under this section: how interest is stated, usury concerns, and penalties.

a) 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%. There is however, no requirement to set out the implied interest rate in commercial lease transactions.

b) Usury Laws.

Canada has no usury statute per se, but overcharging for interest is governed by Section 347 of the Criminal Code\(^5\) 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 provisions to reduce the rate if it is held it 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.

c) 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

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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. In addition, if the late payment provision requires that a certain percentage of the lease payment need be made as a cost for a late payment, then Canadian courts tend to not enforce these provisions. Typically, Canadians have high late payment rates to compensate.

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

3. UCC 2/UCC 2A.

In Canada, there is no equivalent of the UCC’s Article 2A. Accordingly, in a lease, any reference to this provision needs to be deleted. However, the deletion of the Article 2A reference does not mean that many of the protections set out in Article 2A do not exist in Canada. The common law rules, with respect to leasing in Canada, tend to uphold the hell-or-high-water provisions and limit the liability on the lessor with respect to its ownership of the equipment. It should be noted that in Quebec, which is governed by the Civil Code, there are specific provisions built in for leasing with respect to three-party lease transactions, which provide many of the same or similar protections as one receives under Article 2A. Accordingly, the general enforceability that one anticipates in operations in the US would be upheld throughout Canada. It is important to note, however, in the Province of Quebec, a two-party lease that

S.Q. 1991, c.64.
is a direct lease from a manufacturer of equipment to its end user may not be afforded the same protection. Care must be taken to review these transactions to ensure that the hell-or-high-water provisions will be maintained.

4. PIPEDA.

Canada has enacted privacy laws that prohibit the collection of personal information and distribution of said information to third parties without first obtaining the consent of the party who provides this information. This applies only to information acquired from individuals, as opposed to corporations. Accordingly, if the leasing activity undertaken in Canada is strictly with corporations, there would be no requirement to comply with local privacy laws. On the other hand, if there are consumer transactions or if the entities with whom the transactions are being done are unincorporated, consent should be obtained. Further, and a more likely situation, if a personal guarantee is being given with respect to a corporation’s lease, in this case the guarantor’s consent to release information should be obtained. In all cases, it is prudent to develop a privacy policy for this type of information.

It should also be noted that the privacy laws refer not just to the matter of obtaining personal information but also information with respect to employees of the company. Accordingly, many Canadian corporations have developed personal-information policies which govern the collection of data received from employees as well as their respective health records. It is also becoming quite common in purchasing transactions for purchase documents to include a representation and warranty to the effect that the assignor has complied with all laws including, without limitation, privacy laws.


There are no unique Canadian issues when determining what constitutes an event of default. However, in reviewing a security or lease agreement, one must keep in mind that references to the Bankruptcy Code and the UCC must be changed to the Bankruptcy and Insolvency Act, the “BIA”) and the Companies’ Creditors Arrangement Act (the “CCAA”). 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

7 Personal Information Protection and Electronic Documents Act, S.C. 2000, c.5 (“PIPEDA”).
8 R.S.C. 1985,c.B-3
9 R.S.C. 1985,c.c-36
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.


Lease payments are subject to sales taxes, both provincial and federal. The federal tax is referred to as the Goods and Services Tax (“GST”) and, in essence, it is the same as the Value-Added Tax in Europe. The payer of the tax gets a credit against the GST it has paid on this portion. There is no US equivalent to this tax. Provincial sales taxes are akin to state taxes. It is the obligation of the lessor to remit these amounts to the government. The rate of the provincial tax payable is based on the jurisdiction of the location of the equipment of the lessee, not the location of the head office of the lessee. British Columbia, Ontario, New Brunswick, Newfoundland and Labrador, and Nova Scotia have adopted a Harmonized Sales Tax (“HST”), which is the combination of the GST and Provincial Sales Tax (“PST”) into a single value added tax. Note that the HST may differ across these provinces, as each province sets its own PST rates within the HST.

The most significant difference between the Canadian and US tax structures is with respect to property and municipal taxes. There are no municipal taxes whatsoever in Canada at this time, and none are anticipated.

Based on the March 2010 CFLA Tax Update, the following should be noted with respect to the recent GST/HST changes. GST/HST is not payable on the supply of “financial services”. Services considered “arranging for” financial services have also been exempt from GST/HST. Recently, the federal Department of Finance announced its intent to amend the definition of “financial service” for GST and HST purposes effective December 14, 2009 to limit the scope of GST/HST exemption for intermediaries providing “arranging for” services. The proposed changes may reverse long-standing policy in that the amendments to the definition of “financial service” will exclude certain services previously identified in the Canada Revenue Agency (“CRA”) as exempt “arranging for” services. As well, according to GST/HST Notice 250, “facilitatory services” will be excluded from “arranging for” services. As a result, as and from December 14, 2009, the supply of a “facilitatory service” will be subject to GST/HST. A facilitatory service is described as “preparatory to an actual or intended financial service.” Facilitatory services include market research, product design, the collection and collation or provision of
information and other activities. See the CFLA website for examples which illustrate this new policy.


While there is no requirement that leases in Canada be denominated in Canadian dollars, a court 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.

ANCILLARY DOCUMENTS

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

i) 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 of the UCC), (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 Quebec, 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.

ii) 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.

REGISTRATION/PERFECTION

All provinces, except Quebec, 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 Quebec) there is a registration system governed by a 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, 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.
An example is illustrative. Assume Lender A enters into a lease with a lessee who is an Ontario company, but with a division in New York state. The lease is for equipment located in New York. Lender A properly registers in Ontario in time under UCC 9(R) to obtain a purchase-money security interest (“PMSI”), but not in time under the PPSA (under the UCC, there is a 20-day window, and under the PPSA, there is a 10 day window). Further, the lessee has a prior-secured creditor, Bank B, who has a blanket security over all of the lessee’s assets. Lessee becomes insolvent. Under UCC 9(R), Lender A has priority as all steps were taken to obtain the proper PMSI. Under the PPSA, however, Lender A may not have priority and Bank B may try to claim priority under its blanket security. This matter has not yet been litigated; however, it is anticipated that Lender A would prevail, but there may be an interesting argument on behalf of Bank B. Prudently, in such circumstances, it is strongly advised that a waiver be obtained from Bank B.

**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) Equipment Description.

All provinces, with the exception of Ontario, require specific equipment descriptions on the financing statement. The only grey area with respect to registration for these provinces is whether a reference to a lease schedule, rather than a full listing of the equipment, is sufficient. There are various cases with respect to this matter, and this is not settled law. Accordingly, the prudent course of action would be to register in the collateral description area both the lease number, the applicable schedule, and (to the extent possible) the actual equipment subject to the lease. Of course, this could be an administrative nightmare in situations where there are a number of small pieces of equipment being financed, as with a computer system. Generally, our recommendation under these circumstances is to provide a generic description of the equipment so that it can be identified and to list any major components of the system.

Another oddity of the Canadian system is that there are boxes to check to describe the type of collateral that is being financed. In Ontario, the choices 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 box be checked. If you are financing inventory and you check 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 from parties owing to their desire to ensure that there is no security interest in property that they intend to finance.

It should also be noted that, in Ontario, while there is no requirement to provide a collateral description, there is an opportunity to do so. The rationale behind this is that if a finance company is just taking a security interest in one particular asset and does not wish to receive subordination requests from other parties, it can list the assets, with the result that the security interest would be restricted to the assets listed. One problem that is commonly encountered is a registration with a specific asset listed under the general collateral description and boxes marked for, for example, “equipment” and “other”. In this situation, there is no certainty that the collateral description refers to the “other” and, as such, there is a likelihood that subordination letters would be requested, notwithstanding that the procedure being followed was intended to minimize this.

It should also be noted that, in Canada, it is possible to take a security interest in an intangible. Accordingly, it is not uncommon for licensors to provide for a security interest in the licence granted to a licensee and for finance companies to likewise take a security interest in the software. Practically speaking, while it is difficult to resell software, it does have some in-place value and it may provide leverage in an insolvency situation. In these circumstances, the use of the box marked “other” is appropriate.
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.


Much like under UCC 9(R), a creditor can obtain super-priority status if all the appropriate steps are followed to obtain a 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.

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.

ENFORCEMENT/INSOLVENCY

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.
ii) Bankruptcy.

In Canada, there are two basic bankruptcy statutes: the BIA and the 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 creditors. 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 detrimentally affected by these rules particularly if the liquidation value of the inventory will decrease quickly over time.

One significant concern for leasing companies is the effect of the stay on the payment or lease payments during the restructure period. The CCAA and BIA have provisions that if the lease is not a finance lease but a lease for the “use” of the equipment, then payments should be made during the restructure. Courts, however, have taken a very narrow view of what constitutes a lease for use of equipment and lessors who had “true” leases, have been denied payment. While this is an ongoing issue in the Canadian insolvency courts, it would be best to take a narrow or conservative view when underwriting a Canadian transaction. The good news is that Canadian restructurings tend to be much quicker than in the US and the period of time for non-payment may be a number of months rather than years. It should also be noted, that there is no concept or adequate protection rule in Canada. There are also consequences if a lease is determined to be a true or finance lease for the allocation of costs but this is well beyond the scope of this paper.
As noted earlier, Quebec history is different from the ROC. Because of its historical ties to France, as opposed to its English background, Quebec has adopted the *Civil Code*.

While the other provinces of Canada adopted a PPSA, Quebec chose a different regime. It does not use concepts such as security interest but still looks at the ownership relationship with respect to the goods and has significantly different rules in perfecting or noting one’s interest. For instance, if one were to take a security interest in a particular piece of equipment, the documentation utilized in Quebec would not be a security agreement but a hypothec.

The hypothec is much like a mortgage on real property. The hypothec must be registered in accordance with appropriate law. While a US lawyer may be able to grasp what the law is likely to be in the ROC, this would not necessarily be true for Quebec. Accordingly, it is prudent in all circumstances to check with local counsel each time a transaction is undertaken in Quebec. For the leasing industry, this is also problematic. While the actual lease document is not that dissimilar from those which are utilized in the US or in the ROC, the registration process and the protections governed thereunder are different.

First, there is a clear distinction between a two-party and three-party lease. A two-party lease would be one where the seller of the equipment is also the lessor, and the three-party lease would be one where the seller of the equipment sells the equipment to a third-party lessor who then leases the equipment to the lessee and where the lessee has specifically requested the lessor to purchase the equipment. A lessor under a two-party lease is not provided with the same hell-or-high water protections as a lessor who is subject to a three-party lease. This would be of particular importance to a captive finance company that does not set up a separate leasing subsidiary.

Further, the registration process in Quebec is substantially different than in the ROC. Even in a three-party lease situation, there is a distinction between a master lease and schedules thereunder and a lease that is utilized for just a single transaction (often referred to as a “snap lease”). In a master lease situation, the registration must be undertaken prior to the delivery of the first piece of equipment. If the master lease is appropriately registered, all equipment delivered subject to the master lease will be granted priority status. It should be noted that the registration, when undertaken, must set out the goods or type of goods that are going to be subject to the master lease. A snap lease, on the other hand, must be registered within 15 days of the date of execution of the lease. Failure to register within this time frame would result in the registration being null and the lessor being subordinate to a trustee in bankruptcy.

There are no saving provisions currently provided in the province of Quebec if the registration is made late. Further, there is still a debate as to whether the
lack of saving provisions only applies to a trustee or other secured creditors. It should be noted that registering leases in Quebec is relatively new, and the case law is still evolving. The lack of saving provisions is currently before the Quebec courts and may be reversed. However, caution must be undertaken for transactions in this province.

It should also be noted that if the head office of a lessee is in Quebec, registrations may be required for certain types of goods even if the goods are not located in Quebec. In cases where you are dealing with a Quebec company, it would be prudent to review these matters with a Quebec solicitor to determine whether a registration is required in that province.

One further note of caution is with respect to the language that is utilized in the lease. Under Quebec law, a lessee can require a lessor to utilize the French language in all documentation and to conduct all business. While most sophisticated Quebec businesses transact most of their operations in English, government agencies tend to require French documentation. It is common to request counsel from a Quebec firm to provide both English and French versions of a document with an opinion that both versions are one and the same. This of course adds to the transaction costs and may cause a lack of clarity.
CONCLUSION

As noted above, Canada is substantially similar to the US in leasing transactions. The business logic that is applied in determining courses of conduct is essentially the same; however, there are a few differences both culturally and legally that must be taken into consideration when determining an applicable course of action. The advantage is that it allows for easy expansion into new markets.