



Financing a Business Operation in Canada

Doing Business In Canada

Businesses operating in Canada may raise capital through debt and/or equity financing as well as other financing options. In Canada, the most common conventional source of external debt financing is a commercial bank.

Canadian Banking System

Canada has one of the most sophisticated and stable banking systems in the world. The federal *Bank Act* governs the banking activities of Canadian and foreign “banks.” Banking services are provided by Canadian-owned banks (known under the *Bank Act* as Schedule I banks), foreign bank subsidiaries (known under the *Bank Act* as Schedule II banks) and foreign bank branches (known under the *Bank Act* as Schedule III banks). All are subject to supervision by the Office of the Superintendent of Financial Institutions (OSFI), an agency of Canada’s federal government, although the Canadian supervision of foreign bank branches relates only to their business in Canada.

The Canadian Payments Association operates two national payments systems: the Large Value Transfer System for significant electronic wire transfers and time critical payments, and the Automated Clearing Settlement System through which cheques and automated payments are cleared.

All major credit and debit cards are widely accepted in Canada. The Code of Conduct for the Credit and Debit Card Industry in Canada is intended to promote fair business practices and help merchants and consumers understand the costs and benefits associated with credit and debit cards.

Trust, insurance and loan companies — as well as banks — may operate as commercial lenders. Debt financing may also be obtained from credit unions and caisses populaires.

These other types of regulated financial institutions may be subject to federal or provincial government regulation. All regulated financial institutions are subject to laws of general application including laws affecting the nature and distribution of financial products. Cross-ownership of Canadian financial institutions is permitted under the federal legislation and, for example, a bank, trust or loan company may own an insurance company and an insurance, trust or loan company may own a bank. Most trust companies and brokerage houses are owned by one of the major Canadian-controlled chartered banks. However, each of the major types of financial institution retains some exclusivity over core business functions: only a trust company may act as a fiduciary (trustee) and only an insurance company may engage in the business of insurance. Banks, trust and loan companies, themselves, have only limited ability to promote the sale of insurance products or engage in dealing securities.

External Debt Financing

Types of Loans

Third party financiers usually offer operating (a.k.a. “revolving”) or term loans — or a combination of the two — on a secured or unsecured basis. Operating loans are typically offered on a short to medium-term basis to finance the borrower’s (and its subsidiaries’) working capital requirements. Term loans are generally offered on a medium to long-term basis. They are available for a fixed time period and are repayable either in accordance with a prescribed schedule or when a prescribed default event takes place. Oftentimes, they require periodic principal payments, regularly scheduled interest payments and an end-of-term bullet payment.



Domestic and Foreign Banks

In Canada, commercial banks are qualified to provide financial services in Canada under the *Bank Act*. Generally, the least expensive source of funding available from a Canadian bank is a bankers' acceptance (“BA”). A BA is a money-market instrument represented by a short-term note, issued by the borrower, which has been “accepted” — that is, guaranteed — by the borrower’s Canadian chartered bank. This instrument permits any borrower to borrow money at a small premium over commercial money-market rates by, in effect, using the covenant of its banker to lower its cost of funds. The most common funding is Canada dollar loans which are priced in relation to the prime rate of its lender.

Low-risk commercial loans are often done on an unsecured basis. Unsecured loans may require a negative pledge from the borrower to *not* grant a security over its assets (subject to some exceptions). Or, such a loan may require a guarantee from the parent and/or subsidiary and individual shareholders of the borrower. Each Canadian province has a *Statute of Frauds* which requires that agreements in the nature of guarantees be in writing and signed by the guarantor. For example, Alberta’s *Guarantees Acknowledgment Act* provides (with limited exceptions) that no written agreement by any person other than a corporation has any effect unless the person entering into the agreement:

- ◆ Appears before a notary public;
- ◆ Acknowledges to the notary public that the person executed the guarantee; and
- ◆ In the presence of the notary public signs a statement in the prescribed form.

More commonly, a commercial bank will require security (and may also require guarantees from the parent and/or subsidiary and individual shareholders of the borrower). In that case, the borrower will charge all or part of the property and assets of the business including accounts receivable, inventory, fixed assets and real estate. If the borrower defaults under the terms of the loan, the bank may sell or take ownership of the secured property. Often, banks will enter into loan arrangements based upon short-form commitment letters or promissory notes and the granting of security by way of a general security agreement, without the requirement of a long (and expensive) loan agreement. (See “**Personal Property Security Regime**” below.)

While loans are usually made in Canadian or US dollars, Canadian banks will also lend in currencies other than Canadian dollars and can determine interest rates on borrowings with reference to LIBOR (the “**London Interbank Offered Rate**”) or other reference rates. Advances under credit facilities will often provide for advances by way of a letter of credit or letter of guarantee, depending on the needs of the borrower. A borrower may require a hedging program to attempt to mitigate the risk of interest rate, or exchange rate, fluctuations.

In addition, in Canada loans are available from lenders with specialized industry knowledge who are able to make credit advances using higher margin rates on certain equipment and other collateral (asset-based lending) that are larger than would be available from conventional lenders. These credit arrangements are generally more complex, require timelier and more extensive reporting, and may involve lock-box bank accounts under the sole control of the lender into which borrower receipts are deposited on a daily basis.

Personal Property Security Regime

Short or long-term loans may be secured against the personal or real property of the borrower. (For loans secured against real property, see “**Security on Land in Ontario**” below.) All of the common law provinces and territories in Canada have personal property security regimes that govern the taking of security over a business’s personal property. Québec has a separate province-wide system for registering public notice of security governed by the *Civil Code*. The *Personal Property Security Act* (“**PPSA**”) of each common law province and territory is based (in part) on Article 9 of the US *Uniform Commercial Code*.

The PPSA permits a debtor to grant a security interest (a charge) to a creditor by charging any form of personal property in which the debtor has an interest. This regime also includes rules for any lease, no matter its form, with a term of more than one year. The charge either secures the debtor’s obligations to the secured party under a security agreement, or secures the obligations of another person (i.e., where the debtor pledges collateral as security but does not assume any obligation under the other person’s agreement with the secured party). Filings in the public register maintained by each common law province and territory are done by remote electronic access as are the searches of those public registers.



Generally, priorities of security interests are determined by order of “perfection” of such interests. For collateral other than financial assets, perfection is usually achieved by registration of a financing statement in the appropriate PPSA public register; however, there are many other provisions of the PPSA which trump the order of PPSA registration. The PPSA also permits a debtor to grant a purchase money security interest (“**PMSI**”) in the nature of vendor take-back financing or third party equipment lease or purchase financing. The PMSI is granted in favour of a secured lender who restricts the charge of the PMSI to the goods so financed and any traceable proceeds derived from such goods.

Bank Act Security

The *Bank Act* permits certain categories of borrowers (such as farmers and manufacturers) to create and grant special security in raw materials, work-in-progress, finished goods inventory, and specific assets and equipment in favour of Canadian chartered banks. The security gives the bank the same rights as a holder of a bill of lading. Since the statute requires physical registration of notices, commercial banks usually require security under both the applicable provincial PPSA and, where appropriate, the *Bank Act*.

Security on Land in Ontario

A borrower who has an interest in real estate may charge that interest by way of a mortgage or charge in favour of a creditor. Ontario’s electronic land registration system permits remote electronic access registration of transfers, mortgages and documents affecting title to real estate in the province. Title insurance is available in Ontario and its use is becoming more widespread, especially among commercial lenders. Since it usually takes several weeks to receive replies from municipalities about compliance with applicable zoning by-laws and the payment of taxes, title insurers will bind themselves by issuing title insurance without waiting for such off-title searches. In doing so, the title insurers assume the risk of any loss arising out of non-compliance.

Other Financing Sources

There are other sources of financing available to companies specifically to fund asset acquisitions. Capital assets acquired from a manufacturer on a conditional sale basis

permit the company to use the assets while paying for them out of cash flow over time. Lease finance companies buy assets that the company wants and then lease those assets to the company. The company has use of the assets while paying installments over the term of the lease, and then has the option to buy the assets at the end of the lease.

Certain assets of the company may also be pooled and transferred into a separate legal entity. That entity then finances the purchase of such assets by issuing debt (or debt-like instruments) into the capital markets that is secured by the assets themselves. This form of financing is known as securitization.

Another form of financing involves a company selling its accounts receivables to a third party who advances a percentage of the amount of the receivables to the company. Once all of the receivables are paid in full, the third party will advance the remaining balance, net of any fees and interest charges, to the company.

External Equity Financing

Equity financing involves the issuance of shares of capital stock of a company. Private equity funds are a source of external equity financing that may occur in various stages of a company’s growth cycle (i.e., during a start-up or expansion phase or [in Canada, in particular] to fund a buyout). Many such funds are industry or jurisdiction-specific. For start-ups with perceived long-term growth potential that do not have access to capital markets, venture capital (a subset of private equity) may be an option. Due to the high-risk nature of such an investment, controlling ownership of the company is typically demanded. (Alternatively, a minority equity interest may be agreed to in exchange for substantial influence over the management and/or direction of the company). The ultimate objective of a private equity investment is to see the company through its initial public offering and then to sell the controlling (or minority) interest to the investing public at a steep profit.

Note that the issuance of, and trading in, securities (i.e., shares) is governed by provincial securities legislation. Each province and territory in Canada is responsible for the regulation of securities. While some of the provinces and territories have harmonized certain elements of securities regulation, Canada does not have a federal securities regulator.



Aircraft Equipment Security/Financing

Canada — and 12 of its 13 provinces and territories (with the exception of New Brunswick which is expected to follow soon) — have passed legislation implementing the Cape Town Convention and the Aircraft Protocol (together, the “CTC”). This significantly affects the practices for Canadian aircraft sale, financing and leasing transactions. In particular, registrations and priority searches now have to be completed at the International Registry in addition to registrations and searches under the relevant PPSA or *Civil Code* in Québec. In addition, an Irrevocable De-Registration and Export Request Authorization now must be deposited and registered with Transport Canada (this replaces the contractual Irrevocable Power of Attorney previously typical in aircraft finance or lease transactions). This new regime should be carefully considered by any entity looking at selling, financing or leasing aircraft in Canada.

Usury Law

In Canada, pursuant to the *Criminal Code*, it is an offence to charge interest higher than the criminal rate — which is 60% per annum. This is vastly different than in the US, where each state has its own statute dictating interest rates that can be charged before they are considered usurious or unlawful.

Public Financial Assistance for Business in Canada

The federal government and each of the provinces offer government support programs. These programs can include incentives and subsidies or offer assistance with the facilitation of financing.

Federal programs include Export Development Canada which provides risk insurance for Canadian exporters, loans to foreign purchasers of Canadian capital goods and guarantees to Canadian banks for export loans along with management training programs. The Business Development Bank of Canada provides high-risk loans to small- to medium-sized Canadian businesses. Under the federal Scientific Research and Experimental Development Tax

Incentive Program, qualifying companies are entitled to an income tax credit of up to 35% of qualifying research and development expenditures.

In addition, each province offers its own investment programs. For instance, the Ontario government supports local business enterprises primarily through special provincial, industry-specific tax incentives (i.e., the Ontario Emerging Technologies Fund) and tax credits (i.e., the Ontario Innovation Tax Credit).

Special Requirements for Doing Business with the Federal and Provincial Governments

There are a number of statutes that govern how businesses deal with the Government of Canada. This legislation includes: the *Federal Accountability Act*, which prohibits all corporate and union direct or indirect financial contributions of any kind to candidates or political parties at the federal level; the *Conflict of Interest Act*, which prohibits public office holders from exercising an official power to further their own private interests or that of any other person; the *Canada Elections Act*; the *Lobbyists Registration Act*, which imposes stringent rules surrounding lobbyists; the *Public Service Employment Act*; the *Access to Information Act*; the *Public Servants Disclosure Protection Act*; and the *Financial Administration Act*. In addition, there are a number of provincial statutes (e.g., Ontario’s *Financial Administration Act*) that govern or limit dealings with the various provincial governments in Canada and any entity dealing with either the federal or provincial governments should consider all applicable legislation.



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