The Canadian Equipment Finance Environment:

An Overview for European Professionals

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THE CANADIAN EQUIPMENT FINANCE ENVIRONMENT AN OVERVIEW FOR EUROPEAN PROFESSIONALS (BUSINESS AND LEGAL)

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Introduction

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

As trade grows, so does the need to finance the products that are being sold. Traditionally and due to certain tax laws, European finance companies were required to enter into arrangements with Canadian domestic finance companies. However, recent changes to Canadian tax law now permits certain cross-border transactions to take place on more competitive circumstances and as a consequence there is likely to be more cross-Atlantic finance transactions. To date, only a relatively few multi-national banks and finance companies have operations in Canada. With the change in tax laws there are expanding opportunities for those not yet financing products in the Canadian marketplace.

This paper is written from the perspective of a knowledgeable financing professional and addresses 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, from a legal and business perspective, the issues that such financing professional would face in entering or transacting business in the Canadian market.

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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. There are a number of short books prepared by law firms, 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 (eg. size of market, types of leasing, geographical issues) and the second dealing with legal issues.

Part 1 - Business Environment

Canada is geographically large but thinly populated. More than 70% of Canadians live within 70 miles of the U.S. border. The entire population of Canada is roughly 35 million. The majority of Canadians live in Eastern Canada.

Canada is not a homogeneous nation. The most clear divide is the separate nature of the province of Quebec, which was founded by the French and still maintains civil law as its base legal system. The remaining Canadian provinces maintain a common law system similar to that of England but from a commercial perspective have adopted case US style finance and corporate law. Even within these provinces there are many cultural divides which are analogous to the regions that exist in the United States.

British Columbia 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 and fishing industries. The province east of British Columbia, Alberta, is often compared to Texas. Alberta has huge oil reserves and a reputation for entrepreneurship and conservative views. The provinces of Saskatchewan and Manitoba are compared to the Midwestern U.S. 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.

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 ($2 Million).

Size of Canadian market

The estimated size of leased assets under management by Canadian Leasing companies is $112 billion. Non-consumer finance assets represent approximately $54 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 $22 billion in 2008. These estimates are based on a survey of members of the Canadian Finance and Leasing Association. Since the membership does not reflect all of the industry participants it is accepted that the estimates are understated.

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 (Canadian Finance and Leasing Association) 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 these members fund 95% of the leasing business in Canada. The 20 largest Lessors include, among others, global players such as GE Capital, CIT, Bank of America, Wells Fargo, IBM Financial and John Deere Credit. Other Lessors with Assets over $0.5 Billion include four of Canada's largest banks. The smaller private leasing companies are independents, many with very small portfolios.

Distribution of Reported Equipment Assets By Type (2004) (excludes independent & manufacture vehicle lessors).

Rank	Equipment Type	2003	2004
1	Automotive Total	27%	25%
	Trucks	14%	13%
	Trailer	11%	11%
	Buses	2%	2%
	Passenger	0%	0%
2	Construction	12%	13%
3	Manufacturing and Processing	9%	9%
4	Aircraft and Related	7%	7%

5	Office Equipment	6%	6%
6	Computers (Hardware and Software)	6%	5%
7	Medical, Health Services	3%	3%
8	Forestry	3%	3%
9	Mining and Petroleum	3%	3%
10	Materials Handling	2%	2%
11	Office Furniture and Fixtures	1%	1%
12	Store Furniture, Fixtures, Equipment	1%	1%
13	Railway Rolling Stock	1%	1%
14	Agriculture	1%	1%
15	Telecommunications	0%	0%
16	Water Vessels	0%	0%
17	Hotels, Restaurants, Apartments Other	0% 17%	0% 18%

The marketing methods used to originate leases in Canada mirror those of American Lessors. In the smaller ticket leasing business the volume is driven from Vendors and Vendor program. The mid and large ticket Lessors focus more on direct lessee solicitation. Due to the smaller 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 positive image with policy makers. There is still enormous potential for leasing to gain further market share in the Small and Medium sized Enterprises (SME's) market. This market continues to be underserved by the traditional Canadian 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.

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 *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.

Canada has not adopted uniform business procedures and codes for the secured lending business. Consequently, 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 secured lending. The exception to this rule, as will become 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 the province of 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 the province of Quebec. Many of the comments set out in this paper will refer to ROC as opposed to the province of Quebec but, where appropriate, special commentary will be provided with respect to Quebec issues.

It should also be noted that the writers are Ontario solicitors, 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 European headquarters without establishing operations in Canada. This strategy would result

in the lowest transaction costs and have the least legal ramifications, as the host countries law could 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 *Personal Property Security Act*, which governs priority and perfecting issues). Many provisions of this Act cannot be contracted out of, and knowledge of this law is essential. This Act is modeled on the United States Article 9 of the United Commercial Code.

(a) **Withholding Tax**

Unfortunately, for the leasing industry and, to a lesser extent, equipment-based lending industry, cross-border transactions are restricted by virtue of the withholding-tax regime that exist in Canada. Simply stated, if a non-Canadian lessor leases equipment to a Canadian lessee, the Canadian lessee is required to withhold and pay a percentage 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 and the applicable withholding tax was 10%, the Canadian lessee would be required to withhold $100 from the payment and remit to the 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 such lessee, such that the amount received by the 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 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 companies are not in a position to benefit from these foreign-tax credits. Needless to say, requiring a gross-up in a transaction tends to make a non-Canadian leasing company less competitive in the Canadian market as other parties can provide a financial solution at a much lower cost.

In 2008 there was a change to the Income Tax Act (Canada) which eliminated withholding tax on arms length interest payments. Similar to the situation described above, prior law required a certain percent of the interest portion to be withheld and remitted to the taxing authority. Now the entirety of an interest payment on a secured lending transaction can be paid to the lender without attracting any withholding. This is a significant change which now permits any non-resident Canadian lenders to compete with domestic lenders. For the finance industry, it allows non-Canadian lenders to follow their domestic borrower into Canada without having to expose their client to competition from a domestic bank.

In the past, if a company were to enter into a hire purchase agreement (what Canadians call a conditional sales contract) it would require the Canadian purchaser to withhold a certain amount as the interest component. This would make the European seller less competitive than a domestic Canadian company. Due to the change of law, this requirement no longer exists and the

European seller can now compete on an even basis.

It must be emphasized that this is only for a finance and not for a lease transaction, even if the lease is intended as security or has a bargain purchase option. Canadian tax law is a "form over substance" test and, as such, if a document is called a lease it will be treated as such. Hire purchase agreements with a title reservation clause are viewed as a loan and not a lease and therefore do not attract withholding tax.

(b) **Exceptions to Withholding Tax for Lease Transactions**

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

(i) **Type of Asset.** The basic exception depends on the type of asset that is being financed as there are specific exemptions with respect to aircraft and software. If the transaction is based on these types of assets then withholding tax is not an issue and the transaction can proceed without structuring the transaction to dealing with withholding tax.

(ii) **Assignment to Canadian Partner.** The other classic way of avoiding withholding tax is to assign the lease 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. However, 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. Second, the originating institution will

be exposing its client to a Canadian 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.

Establishing Operations in Canada

If it is determined that the most appropriate method of conducting operations in Canada is through the establishment of a Canadian subsidiary, then it must be determined what legal, tax, and other concerns would be faced in establishing these operations.

The concern most commonly raised are the appropriate jurisdiction of incorporation and the structure of the Canadian subsidiary. A corporation can be incorporated under any provincial jurisdiction or under federal law. Generally, most companies that establish operations in Canada tend to choose the federal jurisdiction, but there is no compelling reason to do so.

The cost of incorporating tends to be similar throughout the provinces, and the corporate law statutes are also similar, although the residency requirements of directors do vary and may be a determining factor. Federal companies require that at least 25% of the directors be resident Canadians; provincial legislation in New Brunswick, Nova Scotia, and, most recently, British Columbia, have no residency requirements whatsoever. Canadian incorporation costs are in the $1,500 range.

It is beyond the scope of this paper to discuss the legal and tax implications of establishing a corporation, but it is important to recognize the various complexities.

Bank Act

The other significant issue to be faced in establishing a leasing operation in Canada is whether this operation would be regulated pursuant to the *Bank Act* (Canada)[1]. Recent changes to Canadian law have been made to encourage foreign banks to establish operations in Canada and, in particular, to set up speciality operations. The recent amendments to the *Bank Act* streamline the process allowing a foreign entity to create a financing operation in Canada and to maintain a business without the daunting legal, capital adequacy, reporting, or other regulatory controls previously required.

The first issue is whether an entity would be subject to regulation under the *Bank Act.* The over- simplified answer is that if the Canadian company is “associated” (this term is used in a very broad sense) with a regulated entity, such as a bank, then it would be subject to compliance with the *Bank Act*. Accordingly, if a leasing unit is regulated in its home jurisdiction, it will require approval from the appropriate Canadian regulatory authority. On

[1] S.C. 1991, c.46, as amended.

the other hand, if a finance company in its home jurisdiction is unregulated then it would likewise be unregulated in Canada. Despite this broad assertion, a review of each finance company looking to establish a business in Canada should be undertaken, as many European countries have a much more regulated environment than Canada and as such a non-bank European financial entity may not be caught by the Bank Act. As noted, the definition of "bank" is extremely broad and must be reviewed on a case-by-case basis. Recently, our firm was involved in an uncharacteristic transaction/situation where an international software company, pursuant to its various operations throughout the world, was determined to be a bank for the purpose of the *Bank Act* and required approval.

Obtaining approval under the *Bank Act* used to be a time-consuming and complex endeavour, requiring special orders from the Office of the Superintendent of Financial Institutions ("OSFI")[2]. Fortunately, it has become much more streamlined, and certain foreign entities can apply for what is referred to as a "non-bank licence" wherein it can perform certain financial transactions in Canada without being subject to the full regulatory regime of the deposit-taking institutions. The non-bank Canadian subsidiary is required to make an application to OSFI setting out the transactions that it is intending to undertake in Canada, and is further required to provide OSFI with relatively simple financial information on an annual basis. As the new rules have not been in existence for very long, it is hard to determine the exact timing required to establish operations and obtain approval. Based on our experience to date and comments made by OSFI, the process should take six to eight weeks from the date all information is provided.

[2] http://www.osfi-bsif.gc.ca.

The most significant hurdle of being regulated under the *Bank Act* is a possible restriction on the size of the residual position that can be taken both on a single-transaction basis and as a percentage of the portfolio. Canadian banks are only able to take a 25% residual on any one transaction and a 10% residual on a portfolio as a whole, and OSFI tends to require foreign non-banks to be on the same playing fields as Canadian banks. Further, it should be noted that Canadian banks are not entitled to lease automobiles.

Document Concerns

The good news for a foreign common law lessor is that in most cases the basic finance document that would be utilized in Canada would be substantially similar to that used in its domestic jurisdiction (assuming the jurisdiction is common law based). The process of amending such documents for use in Canada is often referred to a "Canadianization". For non common law jurisdictions, many of the concerns raised below will likewise be relevant but there may be additional areas that need to be revised. Generally speaking, this is accomplished without re-working substantial provisions of the finance document but fine tuning certain provisions so that they may be applied in the Canadian environment. It should be noted that, within Canada, there is often a two-part process in documentation. Generally, a finance document is Canadianized for use in the ROC and then it is further revised for use in the province of Quebec. In Canada, while it is possible to have a single lease that encompasses both Quebec and the ROC concerns, certain issues in a Quebec lease (while not being offensive to the ROC) appear to be superfluous and, as such, are not utilized in transacting business and may be deleted.

In conducting a Canadianization process, the most common changes are as follows:

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

(a) **Annualized.** In Canada, interest must be set out at an annualized rate. If interest is not set out at an annualized rate then 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. If they fail to do so, the rate will likewise be 5%. This, however, does not apply to lease transactions in which there is no requirement to set out the rate.

(b) **Usury.** 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 my understanding that this is a substantially higher percentage than in most European jurisdictions, and it is unlikely that in a typical finance transaction will run afoul of this particular provision on its face.

Lenders who take warrants or have short term loans may encounter a problem with this provision in the definition of interest, which is broadly defined and usually includes language regarding the aggregate of 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 attached, so not to inadvertently violate these provisions. Canadian solicitors have been debating the impact of violating these

[3] R.S.C. 1985, c.C-46.

provisions, and the results range from overturning the loan entirely to reading down the rate to 60%. In a recent Supreme Court of Canada decision, *New Solutions Financial Corporation* v. *Transport North American Express Inc.*[4], the Court approved the use of "notional severance" as a discretionary remedy in appropriate cases. This technique aims to cure the illegality while otherwise leaving to business and legal terms of the transaction as close as possible to the intentions of the parties. Prior to this decision, courts either eliminated the obligation to pay interest entirely or would sever certain, but not all, interest-payment obligations, which would often result in substantially lower interest payments. Now, 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. In this case, the court did, however, make it clear that the relief being provided would only occur in the correct equitable environment and still left open the possibility that if the conduct of the parties was criminal in intent (e.g., loan sharking), the entire transaction would be set aside. The relief provided by this recent case would only be available in commercial cases.

There is current legislation being proposed that would result in usury laws not applying for purely commercial transactions. If the proposed law is enacted, then concerns regarding usury shall fall away for most non-consumer transactions. The proposed legislation would, however, impose a lower 35% plus prime-rate ceiling for consumer transactions.

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[4] [2004] S.C.J. No. 9.

(c) **Penalties.** The law as to what constitutes a penalty, and as such is unenforceable, is unclear in agreements where, for example, an additional payment is required following a default or late payment (such as 2% of the payment amount). A court may determine this is interest that, when calculated with all other "interest" charges, is subject to, the criminal rate ceiling or that the payment constitutes a penalty. There are numerous cases on this issue, but a consistent and defined result has yet to transpire. However, if the extra charge is seen simply as compensation for true administrative costs, 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 higher the amount, the more likely it is to be considered a penalty.

2. **Registering of the Security Interest.** Canada follows the US model that the perfection of a security interest is achieved by registering a financing statement as appended to the document, although the system in Quebec is different than in the ROC. The location of the equipment is in the applicable jurisdiction to file the interest and if the goods are mobile then registration occurs as to the chief executive office or the borrower. There is no clear definition of chief executive office.

3. **Attorneys/Lawyers and Their Costs.** In documentation in Canada, barristers and solicitors are referred to as "lawyers", and the legal process for awarding costs in a trial matter follows the UK model. In a Canadian lawsuit, the loser is responsible to pay the winner's costs – this is referred to as "cost following the event". Accordingly, in Canadian leases, you will find the parties to be much more willing to accept these changes. Costs are awarded on two different scales: either pursuant to "party and

party costs" or on a "solicitor and its own client costs" basis. The former tends to be lower. Often, leases will be amended to incorporate these concepts. Related to this issue is that jury trials in Canada for commercial matters do no exist and while many leases have a waiver of a jury trial provision, this waiver is mostly meaningless.

4. **PIPEDA.** Canada has recently 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.[5] 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, the guarantor's consent to release of 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

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

effect that the assignor has complied with all laws including, without limitation, privacy laws.

5. **Taxes.** 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, is the same as a Value-Added Tax. The payer of the tax gets a credit against GST it has paid on this portion. In addition, each province (other than Alberta) has provincial sales tax that is payable on such payments. Many provinces are now moving to a Harmonized Sales Tax ("HST") which will combine the GST and PST and will be administered in the same manner as the GST. It is the obligation of the lessor to remit these amounts to the government. The rate of the provincial tax, and in future the HST, 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. There are no municipal or personal property taxes whatsoever in Canada at this time, and none are anticipated.

6. **Default Provisions.** There are no special Canadian issues regarding what constitutes an event of default. However one must be mindful that the damages in the event of a default must not be phrased as penalty and must take into account the time value of money concept. Care must be taken to ensure that the amount due on default is calculated properly.

Finally, one must be cautious about relying on the "material adverse change" clause as an active event of default. Courts in Canada are reluctant to enforce a default

provision if this is the only event that would give rise to a lessor's right to terminate a lease or seize the equipment.

7. **Currency Issues.** While there is no requirement that leases be denominated in Canadian dollars, a Canadian court will not enforce a judgement in a currency other than 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

Canadian transactions use standard credit-support mechanisms that are typical in any financing. There is no prohibition on receiving guarantees from related parties or from a vendor with respect to a recourse transaction.

Registration/**Perfection** of Security Interests

All provinces, except Quebec, have a registration system similar to the United States UCC 9(R). In order to perfect a security interest, 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 are conceptually similar to those under UCC 9(R); however, there are some regional differences among the provinces.

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, with the exception of Quebec, there is currently a priority registration system and it is referred to as

the *Personal Property Security Act* [6] ("PPSA"). Notwithstanding the similarities between the UCC 9(R) and our PPSA, there are specific issues which are unique to Canada.

(a) **Jurisdiction of Registration.** The PPSA follows the rules that existed under UCC 9 in that the proper jurisdiction in which to register a financing statement is the province where the equipment is located. Further, pursuant to the conflicts-of-law provisions, the PPSA in the jurisdiction where the equipment is located will also govern with respect to enforcement procedures and policies.

For mobile goods, the head office of the entity is the appropriate location for registration. Of course, as in the US, perfecting an interest in laptops and other semi-mobile goods can be problematic. The prudent course of action is to register in both the jurisdiction where the equipment is located and the jurisdiction of the lessee's head office. For tractors and motor vehicles it is also prudent, but not required, to register in the provinces where the trucks are ordinarily utilized. For instance, if a corporation has terminals in both the provinces of Ontario and Alberta, it would be prudent to register in each of those provinces, although it is only required to register in the province where the head office is located.

(b) **Debtor Name.** Canada has very specific rules as to the debtor (lessee) name that is to be utilized: a failure to register under the correct debtor name is fatal to a registration. Some provinces have enacted more liberal saving provisions

[6] R.S.O. 1990, c.P.10.

than others. The general rule, however, is that if the name is improperly set out on the financing statement and, as a result, it 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 many Canadian entities have both an English name and a French name. Often, the individuals working for a company would not even have knowledge of the French name of the company (and visa-versa depending on the home jurisdiction). Furthermore, it is quite possible that the registration would not be complete if reliance was placed solely upon information received from the company. For this reason, one should always undertake a corporate search to determine the proper registered name.

(c) **Equipment Description.** All provinces, with the exception of Ontario (and this will be changing shortly), 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.

Ontario has a different system in 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 currently, in Ontario, (and this is to change shortly) 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, unlike many European jurisdictions, 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, in Ontario the use of the box marked “other” is appropriate.

Leases. In Canada all leases must be registered, if the term is greater than one year Canada does not focus on the “title” aspects of the transactions from a security prospective but strictly on the term of the lease.

(d) **Assignment of Accounts Receivable.** Another particular oddity under the Canadian PPSA legislation is the requirement to register a financing statement when there is an absolute assignment of accounts receivable, whether or not such assignment creates a security interest.

For example, if Bank A is purchasing a portfolio or a single lease from Bank B regarding Lessee C, then Bank A is required to register a financing statement against Bank B. If Bank A fails to register its financing statement against Bank B and Bank B were to become insolvent, any amounts owing

from Lessee C to Bank A, pursuant to the assignment, would be subordinate to a trustee in bankruptcy of Bank B. While this result may be counterintuitive, it is a critical consideration when purchasing a portfolio or taking assignment of leases.

(e) **Purchase-Money Security Interest.** An equipment financing can obtain super-priority status if all the appropriate steps are followed to obtain a purchase-money-security interest. The general rule is that there must be a financing statement registered within ten to twenty days (depending on jurisdiction) of delivery of the equipment and the security agreement being executed (in most jurisdictions the financing statement can be registered in advance). While this does not provide for much of a concern with respect to a lease that describes the collateral, there is a concern when there is a long period between the delivery of the equipment, the execution of the lease, and the acceptance of the equipment by the lessee. Until the lessee signs a schedule, it could be argued that there is no executed security agreement between the parties and, as such, the ten-day period after delivery, as is required under the PPSA, would be missed. This is often referred to as a springing security issue.

Even more problematic is a situation where the lessor and lessee enter into some form of lease line or progress payment arrangement whereby a lessor allows a lessee to accumulate equipment over time and to sign a schedule on a periodic basis. Under these circumstances, it is not clear that a purchase-money-security interest would be obtained. There is currently case law that

sets out that the ten-day period does not start to run until the lessee has received the equipment as a debtor. Therefore, if they have not signed a security agreement, it could be argued that the lessee is actually holding the equipment not as a debtor but as a bailee on behalf of the lessor and, as such, the ten-day period would not start to run until all appropriate documentation had been executed. This line of reasoning, while compelling in that it seems equitable and is gaining acceptance with Canadian authorities, has not yet been affirmed by a high court. Accordingly, caution needs to be taken in relying on the purchase-money security rules in case of progress payments.

Enforcement/Insolvency

Canadian insolvency law is both federally and provincially governed. The rules governing secured creditors and enforcing rights absent a bankruptcy are governed by the PPSA, while bankruptcy is governed by federal law. Therefore, absent bankruptcy, the rules of the applicable personal property security registration govern.

(f) **PPSA Enforcement**

In non-bankruptcy situations, the secured party would realize upon its collateral and have an option to either sell the collateral to third parties or foreclose on the collateral. In either case, it 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

specific periods of time set out under each 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. If there is any surplus, it is paid to the debtor, and if there is a deficiency, then the secured creditor can claim such amount as an unsecured creditor. If a secured party were to use the foreclosure procedure, the notices would likewise have to be sent out, 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. Under these circumstances, the secured creditor would not be able 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 equipment. 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 the debtor allows the secured creditor onto its property to seize the goods.

(g) **Bankruptcy**

In Canada, there are two basic bankruptcy statutes: the *Bankruptcy and Insolvency Act*[7] (“BIA”) and the *Companies Creditors Arrangement Act*[8]

[7] R.S.C. 1985, c.B-3.
[8] R.S.C. 1985, c.C-36.

("CCAA"). The CCAA issued for 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. This proposal will set out a proposed settlement with each of its creditors. If this proposal is accepted by two-thirds in dollar amount and 50% in number of each of the classes of creditors then the proposal will be accepted. 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. Of particular concern to a lessor is that, unless the lease is deemed to be a true lease, there is no requirement for the debtor to make any payment to the lessor during the stay period. The debtor is required to file a proposal within 30 days of the date of its filing of the Notice of Intention but can ask for extensions of this time limit for 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 is that it is a relatively inexpensive process and can be accomplished quickly.

Under the CCAA, the process is governed strictly by the court. The CCAA provides for a much more creative regime than the process under the BIA in

> that a debtor is open to making very unusual requests of the court in order for it to be allowed to restructure. Courts have been known to allow stay periods under the CCAA to extend well beyond the seven-month period under the BIA and to compromise claims in manners that would not otherwise be set out. The BIA tends to have very specific rules as to what can and cannot happen during the stay. Under the CCAA, such rules are set out pursuant to court orders and courts tend to be very flexible in providing for relief to assist a debtor in restructuring. For a creditor in a leasing situation, these rules can be quite detrimental, particularly if its liquidation value decreases quickly over time.

Quebec

As noted earlier, Quebec history is different from the ROC. Because of its historical ties to France, 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. For common law lawyers, Quebec law is more difficult to understand. 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.

Under Quebec law, 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.

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