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CROSS-BORDER TRANSACTIONS WITH CANADA

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MATERIALS

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Factoring and Lending in/with Canada-Legal Tips and Traps

U.S. lenders, factors and other business enterprises have significantly increased their Canadian activities. Cross-border loans, securitizations, factoring and sales, as well as Canadian branches and subsidiaries, are all becoming more common. This program will address several legal and business issues which arise from these expanded operations, including Canada's perfection and priority framework for security interests; terms that should be added to U.S. loan and security documents when dealing with Canadian borrowers, guarantors and collateral; Quebec's French language law requirements; Canada's criminal legislation dealing with usury; the legal impact of Canadian currency obligations; Nova Scotia "unlimited liability companies" and the consequences of taking pledges of their shares; Canada's withholding tax regime; litigating against Canadian obligors and enforcement of U.S. judgments in Canada.

Mr. Fingerhut is a Partner in the Financial Services Group and Chair of the Structured Finance Group in the Toronto office of Blake, Cassels & Graydon LLP. Mr. Fingerhut is Chair of the Securitization and Derivatives Subcommittee of the Business Law Section of the American Bar Association and former Vice Chair of the Securitization Subcommittee of the Business Law Section of the International Bar Association. He was a member of the Expert Advisory Group to UNCITRAL with respect to the Convention on the Assignment of Receivables in International Trade. In addition to domestic transactions, he advises US, and European corporations and financial institutions with respect to cross-border lending, securitization and factoring

transactions and programs. Mr. Fingerhut is listed in the American Lawyer/Lexpert Guide to the Leading 500 Lawyers: Canada, in the Chambers guide to the leading Canadian banking and finance lawyers, in the Canadian Legal Lexpert Directory of leading lawyers in banking, asset/equipment finance and asset securitization, in Law Business Research International Who's Who of Business Lawyers, and in Euromoney's Guides to the World's Leading Capital Market and Securitization Lawyers. Mr. Fingerhut is a Fellow of the American College of Commercial Finance Lawyers and sits on its Board of Regents.

CLE CREDIT: One credit hour in Professional Practice, Commercial Law, for attorneys admitted in New York who are members of ACFA. Members admitted in other jurisdictions with CLE requirement should consult with the appropriate bar organization for that jurisdiction.

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Factoring and Lending in/with Canada

Legal Tips and Traps

Canadian Personal Property Security Regime

- Two legal systems regulate perfection and priority in Canada.
- Most Canadian jurisdictions – nine provinces and three territories – have a Personal Property Security Act (“PPSA”) modelled on Article 9 of the UCC (former rather than revised Article 9, resulting in different rules for filing, perfection, etc.).
- Quebec’s rules are derived from the Civil Law of France, but recent amendments provide for an Article 9-type filing system. Security must be taken under a unique security instrument (a “hypothec”) and is subject to special rules and principles.
- Quebec also has special requirements for perfecting absolute sales of receivables (including factoring & securitization). Perfection by registration is only possible if the receivables form a “universality” (a not perfectly-understood concept relating to “classes” of receivables). Otherwise, perfection can be achieved only by notifying the account debtor.

Canadianizing U.S. Security and Factoring Agreements

Relatively few modifications are necessary to adapt U.S. forms for use in Canada (other than Quebec), including:

- Canadian security agreements commonly have “receivership” provisions which enable the secured party to appoint a receiver to take over and manage the debtor’s business.
- Clarify true sale terminology in factoring agreements – Canada is more form-conscious than the U.S., and factoring agreements should contain clear and unambiguous “absolute sale” terminology.
- Collateral – normally possible to obtain security over all of a commercial debtor’s present and future property.
- Completing financing statements – may require individual’s date of birth and middle initial, or debtor’s second given name. If corporate debtor has both an English and French form of its name, each must be set out on the financing statement.

French Language Requirements

- Not necessary to translate agreements into French; Quebec standard form agreements should state (in both languages) that the parties have required the agreement to be drawn up in English only.

Interest

- Canada's usury legislation is essentially federal, and is set at 60%; "interest" defined very broadly, and includes all charges, expenses, bonuses and fees; a recent case included certain "royalties" in the interest calculation.
- Lending agreements commonly contain an elaborate provision disclaiming an intention to charge or collect interest at a usurious rate.
- Interest must be expressed as an annual rate (e.g. 12% per annum rather than 1% per month); a 360-day interest rate clause usually includes a formula which permits calculation of the equivalent annual rate.
- Usually unable to charge penalty interest on debt secured by real estate.

Government Obligations

- Consent required in order to assign accounts receivable owing by the Canadian federal government, certain federal government corporations, and certain provincial governments.
- Anti-assignment clauses – Ontario and Quebec do not have legislation which nullifies contractual anti-assignment clauses; if underlying contract clearly prohibits assignment, assignment will be void as against the obligor.

Currency Issues

- Consider revising monetary limitations or events to take into account the different value of the Canadian dollar (e.g. maximum program amount, amount of permitted judgments, and dollar amounts in cross-default provisions).
- Canadian courts give judgment only in Canadian currency; contract relating to a U.S. dollar obligation should contain a provision requiring debtor to indemnify for losses that may result from the conversion into U.S. funds of payments made under a Canadian dollar judgment.
- Consider need to hedge the exchange risk; required by rating agencies in connection with U.S. securitizations of Canadian dollar obligations.

Canadian Withholding Tax

General – Canada imposes withholding tax on payments of interest or rent by Canadian residents to non-residents.

- Subject to a number of exceptions, withholding tax applies if loan is made by U.S. lender to Canadian borrower; or if U.S. factor purchases Canadian receivables which include interest or rent.
- Most trade receivables are not interest bearing – and therefore not subject to withholding tax (other than for default charges).
- Statutory withholding tax rate – 25%. Often reduced by treaty. Treaty rate for payments to U.S. residents is 10%.
- Consider whether U.S. lender is able to utilize foreign tax credits to offset effect of withholding tax.
- If Canadian debtor is to be responsible for withholding tax, agreement should contain a “gross-up” clause to allocate this risk.
- Most common withholding tax exemption: no withholding tax if arm’s length loan, which is made to a Canadian corporate borrower, does not require repayment of more than 25% of principal in first five years (except for default). Voluntary payments normally not a problem.
- U.S. and Canadian governments have tentatively agreed to eliminate withholding tax on cross-border interest payments; elimination will present a significant opportunity to U.S. short-term and operating lenders.

Guarantees

Canadian issues to be kept in mind:

- Individual guarantor in Alberta must complete a prescribed form in the presence of a notary.
- Canadian courts attempt to protect guarantors. Guarantee should clearly and specifically waive numerous possible defences that might be available (e.g. amending guaranteed obligation without guarantor’s consent, increasing or reducing interest rate of guaranteed obligation, releasing security given by debtor or another guarantor).
- Cross-border guarantee should contain gross-up clause to cover withholding tax on interest or rent paid by guarantor; also currency clause making guarantor liable for currency risk if U.S. dollar liabilities are paid in Canadian funds.

- Generally easier than in U.S. to obtain valid guarantees from affiliates. Applicable incorporating statute must be reviewed, and is usually quite liberal.

Litigating in Canada

- Foreign litigants without significant Canadian assets may be required to post security for costs.
- Canadian courts generally enforce arbitration agreements, choice of law clauses and choice of venue clauses.
- Foreign judgments will generally be enforced by Canadian courts if defendant given procedural fairness and foreign court properly took jurisdiction.
- Commercial disputes are almost always decided by judges without a jury.
- Unsuccessful party is normally required to pay a portion of successful party's legal costs.
- Class actions are relatively rare, but growing in frequency.
- Punitive damages are much lower than in the U.S., and much less frequently awarded.

Share Pledges

- Determine whether pledged shares relate to a Nova Scotia unlimited liability company. Owner of these shares is liable for all of the company's obligations.

Regulatory Issues

- "Foreign banks" require regulatory approval to carry on business in Canada. Relatively easy to structure lending transaction under which lender is not carrying on business in Canada although it is dealing with Canadians.

Taxation

U.S. lenders and factors must be careful to avoid becoming subject to Canadian taxation.

- Factoring arrangement may appoint Canadian seller as U.S. purchaser's agent for the purpose of collecting purchased receivables. Agreement should indicate that seller does not have general authority to make contracts on behalf of the purchaser; otherwise, the purchaser may be deemed to have a Canadian "permanent establishment" and become subject to Canadian taxation.
- Other elements of a "permanent establishment" should be avoided, such as opening a Canadian office.

Remedies

- Seizure and sale of real estate is usually easier and quicker than in the U.S.
- Assigning debtor into bankruptcy may defeat certain prior government claims (which are unsecured in bankruptcy), and will prevent a landlord from exercising its right to terminate the lease or to distrain against the tenant's equipment.
- Secured creditor must give insolvent debtor a prescribed notice of the creditor's intention to enforce security against all or substantially all of the debtor's inventory, accounts receivable, or other business assets; security may not be enforced for 10 days after notice is sent (unless the debtor otherwise agrees after receipt of notice).

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