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Cross-border lending in Canada: what you need to know

MAY 2, 2022 16 MIN READ

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As globalization of business operations and financial services continues to accelerate, notwithstanding the restrictions imposed since the outbreak of the COVID-19 pandemic, cross-border structural features are becoming increasingly prevalent in bilateral and syndicated loans. As the Bank for International Settlements recently indicated, banks' cross-border claims increased by US$228 billion in Q3 of 2021, a 3% increase from 2020.[1] In this article, we discuss certain key Canadian issues that may be relevant for lenders and borrowers engaged in loan transactions that contain a Canadian nexus (e.g., a Canadian borrower, Canadian guarantors or collateral located in Canada).

Overview of Canadian secured transactions

Many foreign lenders and borrowers will be familiar with the secured transactions regime set out in Article 9 of the Uniform Commercial Code (the UCC) in the United States. In each of Canada's nine common law provinces and three territories, secured transactions are governed by a *Personal Property Security Act* (PPSA) that is largely similar to, and based upon, the UCC. As with the UCCs adopted by each U.S. state, the PPSAs vary slightly between provinces and territories but are mostly harmonized across jurisdictions. Therefore, foreign lenders and borrowers will find that closing a cross-border loan with a Canadian nexus should be quite similar to closing a U.S. loan transaction but will require consideration of, among others, the Canadian-specific issues discussed below.

It is important to note, however, that the bijural nature of Canada's legal system requires special consideration with respect to the province of Québec. Unlike the common law PPSA provinces and territories, Québec civil law — and in particular the *Civil Code of Québec* (the CCQ) — governs secured transactions in Québec. A comprehensive discussion of Québec civil law is outside the scope of this article but we discuss certain key Québec law considerations below.

Perfection issues

Conflict of laws issues

The PPSA conflict of laws rules have not been harmonized with the UCC's straightforward "registered organization" debtor location rule, whereby such a debtor is deemed located, and a UCC-1 financing statement need only be filed, in the debtor's jurisdiction of formation. Rather, the PPSA provides that the validity, perfection and effect of perfection or non-perfection of security interests in goods (and possessory security interests in certain other tangible collateral) is governed by the law of the jurisdiction where the collateral is situated at the time the security interest attaches. With respect to security interests in intangibles and goods that are equipment or inventory and of a type normally used in more than one jurisdiction, the PPSA conflicts rules point to the debtor's location. However, not all PPSAs have adopted the UCC's debtor location determination rule (i.e., deeming a debtor to be located in its jurisdiction of formation). While commercially significant jurisdictions such as Ontario and British Columbia have harmonized their debtor location determination rules with the UCC in recent years, other provinces such as Alberta and Nova Scotia still use a principal place of business or chief executive office rule for determining a debtor's location. These tests are highly fact-specific as these PPSAs do not contain definitions of "principal place of business" or "chief executive office".

Therefore, lenders need to conduct standard due diligence PPSA searches and register PPSA financing statements in any province or territory in which a debtor's tangible collateral is located. Lenders also need to pay special attention to the various PPSA debtor location rules to ensure that all appropriate financing statements and other perfection steps have been taken in the applicable jurisdictions. Where the value of a Canadian loan party's collateral in a particular jurisdiction is minimal, however, borrowers often seek to negotiate threshold-based carveouts from certain perfection-related obligations (e.g., no local counsel perfection opinions required in a particular jurisdiction unless and until a specific value threshold of collateral in such jurisdiction is exceeded).

Perfection against cash collateral

Cash collateral in the form of deposit accounts is one of the most important forms of collateral in secured lending. However, unlike the UCC, the PPSAs do not provide a method to obtain perfection by control over deposit accounts. Under the PPSA, deposit accounts are not a distinct category of collateral. Rather, they fall under either or both of the categories of "accounts" and "intangibles".[2] Since deposit accounts cannot be subject to possessory security interests, the sole method for perfection under the PPSA is by registration of a financing statement against the debtor/account holder. This is in stark contrast to UCC practice, which typically involves a tri-party deposit account control agreement (DACA) among the debtor/account holder, lender and depository institution in which the depository institution agrees to comply with the instructions of the lender.

While DACAs are not a perfection requirement under the PPSA, blocked account agreements (BAAs) that are substantively identical to U.S.-style DACAs are commonly obtained with respect to Canadian deposit accounts to provide a lender with practical (but not legal) control over such accounts. In the absence of any statutory perfection requirement under the PPSA for a BAA, third-party depository institutions in Canada may be less likely to enter into BAAs and borrowers therefore sometimes wish to qualify any requirement to deliver BAAs over Canadian deposit accounts by a "commercially reasonable efforts" standard. However, for asset-based lending (ABL) in particular, where eligible accounts and cash proceeds are critical components of collateral, BAAs are typically required to be delivered.

In 2015, Québec amended the CCQ to facilitate the perfection of security interests in cash collateral in a manner similar to perfection by control under the UCC. Proposals to make similar changes to Ontario's PPSA have been made in the past but the Ontario government has not yet undertaken any PPSA reforms to address these proposals.

Additional security issues

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Québec security

When a transaction involves collateral located in Québec or a Québec loan party, security will typically be taken under Québec's civil law. The civil law equivalent of a security interest under the PPSA is a "hypothec" under the CCQ. A hypothec is a real right on movable or immovable property made liable for the performance of an obligation and is granted pursuant to a deed of hypothec, the civil law equivalent of a security agreement. The hypothec functions like a PPSA security interest and gives the creditor the right to follow the property into whoever's hands it may fall and to exercise hypothecary rights (e.g., taking the collateral in payment of the secured obligations or forcing a judicial sale). As with the PPSA, the CCQ provides for the "publication" of hypothecs (i.e., the civil law equivalent of a financing statement registration) with Québec's Register of Personal and Movable Real Rights (the RPMRR). Priority of competing hypothecs is generally determined by the date and time of publication. The CCQ facilitates the concept of a collateral agent for syndicated loans by way of the appointment of a "hypothecary representative" under the loan agreement. The hypothecary representative acts on behalf of the other secured parties with respect to the Québec hypothec.

However, notwithstanding the conceptual similarities between Québec hypothecs and PPSA security interests, there are practical differences of which lenders and borrowers should be aware. Firstly, unlike a security agreement under the PPSA, a deed of hypothec cannot secure future advances in an undetermined amount. Rather, the hypothec may only secure a stated amount in Canadian dollars. Since the amount cannot be amended, the amount must be sufficient to secure the obligations described in the deed of hypothec (i.e., the principal obligations, interest, any applicable secured hedging obligations, fees and expenses). Practically speaking, then, lenders often err on the side of caution and stipulate a larger amount than the principal of the facilities, especially if the loan agreement contemplates future increases to the facilities (e.g., an accordion feature). Market practice is to determine the hypothec amount by adding approximately 20% to the total amount of the credit facilities. If the facilities are not denominated in CAD, the amount is also typically adjusted further to address currency fluctuations (e.g., for USD facilities, 150% in CAD of the USD facility amount). Borrowers who have not previously dealt with Québec security are often initially surprised to see the hypothec amount greater than the credit facilities. However, they can take comfort that the secured party, when exercising its hypothecary rights, can only enforce with respect to the actual amount of the obligations owed, regardless of the stated amount of the deed of hypothec.

When a deed of hypothec is required, borrowers and lenders will need to be aware of the Québec-specific execution requirements. A deed of hypothec granted in favour of a hypothecary representative (i.e., a collateral agent) must be executed by the hypothecary representative and the grantor in person before a licensed Québec notary; otherwise, it is void. Since this is not practical for signatories who may be located in other jurisdictions, each of the hypothecary representative and the applicable grantor will typically authorize its respective Québec counsel to execute the deed of hypothec on its behalf. In the case of the hypothecary representative, the authorization may take the form of a limited power of attorney, and the applicable grantor will typically include such authorization in its standard resolutions approving the entire loan transaction. The Québec notary will require such evidence of authorization in order to proceed with in-person execution.

Since a deed of hypothec cannot be "published" (i.e., registered) by filing with the RPMRR prior to its execution, if a deed of hypothec is a condition precedent to closing, the applicable authorizing resolutions will need to be passed sufficiently far in advance of closing to ensure that Québec counsel has time to coordinate for execution before the Québec notary and file the deed of hypothec with the RPMRR.[3] In acquisition financings where the pre-closing board of directors of the hypothec-granting loan parties will be replaced on closing and it will be the post-closing board authorizing the security, it is typical for a Québec deed of hypothec to be a post-closing deliverable instead.

Bank Act special security

In addition to PPSA security, section 427 of the federal *Bank Act* includes a special regime for taking security by Canadian domestic Schedule I banks and Schedule II foreign bank subsidiaries over specific assets of certain types of borrowers (including manufacturers and farmers). *Bank Act* security can only be provided by the borrower and not a third party (e.g., a guarantor). Therefore, *Bank Act* security searches are standard due diligence lien searches in Canada in addition to PPSA searches.

Where *Bank Act* security may be taken, it should be noted that it is a distinct process for taking security and is virtually always undertaken concurrently with standard PPSA security (i.e., a security agreement and PPSA registrations).

Bank Act security is granted pursuant to prescribed forms, rather than a customized security agreement. The forms are set forth in the *Registration of Bank Special Security Registrations* and consist of the following:

- Notice of Intention (NoI)
    - The NoI is filed with the office of the Bank of Canada located in the province in which the borrower has its place of business or, if more than one, its head office.
    - Registration of an NoI is effective for five years but banks must send annual notices to the Bank of Canada listing any NoIs scheduled to expire that year that the bank wishes to preserve in subsequent one-year periods.
- Special Security
    - An assignment of property creating the *Bank Act* special security interest.

Bank Act security operates as a transfer of title in the collateral to the bank. This provides ABL lenders in particular with a potential advantage over landlords of borrowers, since a landlord will not be able to exercise its distress rights against such collateral following the title transfer. However, case law has limited the value of *Bank Act* security against other secured creditors. Bank lenders that are eligible to take *Bank Act* security will therefore take and perfect security under both the *Bank Act* and the PPSA.

ULC pledges

Unlimited liability companies (ULCs)[4] are a particular feature of the business corporation statutes of certain provinces.[5] Typically incorporated for tax structuring reasons, ULCs pose a risk to lenders taking a pledge of its shares because shareholders of ULCs have unlimited liability for the ULC's obligations. Lenders taking security from a shareholder of a ULC will therefore want to ensure that the pledge/security interest alone does not make the lender a shareholder and that, in an enforcement situation, it will not become a shareholder without express action on the lender's behalf. Taking a security interest in, and physical possession of, ULC share certificates with a share transfer power should generally not result in a lender becoming a shareholder. However, it is common for any general security agreement, pledge agreement, share charge or other similar security document that charges ULC shares to include a ULC provision that limits the potential for a lender to obtain any traditional share ownership rights (e.g., registration of the lender as the shareholder in the ULC's shareholder register, voting rights or the right to receive dividends) without positive action on the lender's behalf.

Interest Act disclosure

When interest in a credit agreement is payable at a rate for any period less than a year, section 4 of the federal *Interest Act* requires express disclosure of the equivalent annual interest rate in a credit agreement. If no such disclosure is included, a lender will be prohibited from charging interest in excess of 5% per annum. This issue is particularly relevant for lenders where facilities are subject to floating rates that are calculated on a 360-day or 365-day period. To avoid the harsh consequences of failing to include *Interest Act* disclosure, an equivalent annual rate calculation provision is often included stating that the equivalent annual rate of any rate computed on the basis of a period less than a calendar year is equal to such rate multiplied by the actual number of days in the applicable calendar year and divided by the applicable period that is less than a calendar year. In 2018, the Court of Appeal for Ontario confirmed that such formula, which produces a *nominal* annual rate rather than an *effective* annual rate, is sufficient to provide an "equivalent" rate for purposes of the *Interest Act*.[6]

Canadian amalgamations vs. U.S. mergers

Particularly with respect to cross-border acquisition financings, foreign lenders and borrowers should be aware of a unique feature of Canadian M&A practice that affects Canadian loan documentation. Unlike mergers under U.S. corporate statutes such as Delaware's General Corporation Law in which one of the merging corporations survives post-merger, the concept of a "merger" does not exist in Canada. Instead, amalgamations of corporations under Canadian business corporation statutes result in the continuation of a new amalgamated corporation (Amalco) that is a distinct legal entity. [7] The Supreme Court of Canada famously held, in *R. v. Black & Decker Manufacturing Co.*, that an amalgamated corporation is akin to "a river formed by the confluence of two streams." To protect creditors of the pre-amalgamation corporations, business corporations statutes expressly provide that the property of each amalgamating corporation continues to be the property of Amalco and that Amalco continues to be liable for the obligations of each amalgamating corporation.[8]

However, from a loan documentation standpoint, it is common for an amalgamation of Canadian loan parties to require delivery of any or all of

- a confirmation/reaffirmation agreement from Amalco in which Amalco confirms that it is bound by the pre-amalgamation corporations' obligations (i.e., borrowings, guarantees and/or security)
- financing change statements with respect to any existing PPSA registrations against the amalgamating corporations
- legal opinion(s) with respect to Amalco
- new pledged equity interest certificates and transfer powers in the name of Amalco

In acquisition financings where post-closing amalgamations of Canadian loan parties are contemplated (such as an amalgamation of a special purpose acquisition corporation with the target) such deliveries will typically be documented as post-closing obligations within a specified period of time.

Enforcement issues

Section 244 notices: the 10-day waiting period

Section 244 of the federal *Bankruptcy and Insolvency Act* (the BIA) limits a secured creditor's ability to enforce its security in Canada. In addition to the common law requirement to provide a debtor with a reasonable time to pay on any demand prior to enforcing security established in the Supreme Court of Canada's seminal decision in *Lister v. Dunlop*,[9] section 244 contains a minimum statutory 10-day notice that a secured creditor must provide prior to enforcing (including by way of appointment of a receiver) on all or substantially of the inventory, accounts receivable or other property of an insolvent person that was acquired for, or is used in relation to, a business carried on by the insolvent person.[10] The insolvent person may consent to earlier enforcement but only after receiving the prescribed notice. If the secured creditor is concerned that the debtor's assets are at risk before the 10-day notice period expires, the secured creditor may apply to the court for the appointment of an interim receiver under section 243 of the BIA.

A receiver appointed pursuant to the BIA is a "national receiver" with jurisdiction across Canada. However, in Québec, where there are no additional provincial law provisions for the appointment of a receiver, the CCQ further restricts the appointment of a BIA receiver. The Québec Court of Appeal has held that to appoint a national receiver pursuant to the BIA with respect to property located in Québec, a secured creditor must also comply with the CCQ provisions regarding the exercise of a hypothecary right (i.e., the issuance and expiry of a 20-day notice for movable property or 60-day notice for immovable property).[11]

Judgment currency

When a Canadian loan party is party to a loan document or there are otherwise obligations that could potentially be enforced in a Canadian court, a standard judgment currency conversion clause is typically included in the relevant loan document.

The federal *Currency Act* requires that any judgment of a Canadian court be stated in the currency of Canada. Therefore, any claim under a loan document that is brought in a Canadian court for enforcement must be converted to Canadian dollars. The rules governing the timing and exchange rate for such conversion differ by province. For example, in Ontario, section 121 of the *Courts of Justice Act* provides that if the parties have provided for the manner of conversion in the contract, the court will give effect to the chosen method but, if not, the court will convert the foreign currency on the basis of the exchange rate at an Ontario bank on the day before payment is made (or such different date as the court may select if such default conversion method would be inequitable to any party).

Given the potential for deficient recovery of a Canadian court judgment in Canadian dollars due to exchange rate risk, a standard judgment currency clause is typically included that provides that the exchange rate shall be the one at which the lender could purchase the agreement currency with the judgment currency on the business day immediately preceding the judgment and the debtor's obligations shall be discharged only to the extent that the lender may purchase the agreement currency with the judgment currency (with a separate indemnity in favour of the lender for any deficiency and an obligation on the lender to return any excess to the debtor).

Conclusion

As the foregoing indicates, lenders and borrowers interested in structuring a cross-border loan with a Canadian nexus should be aware of the unique Canadian legal issues that may impact their transaction. Osler's professionals are experienced in advising clients concerning cross-border lending.

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[1] The Bank for International Settlements, *BIS international banking statistics and global liquidity indicators at end-September 2021* [PDF].

[2] For example, under Ontario's PPSA, an "account" is a monetary obligation not evidenced by chattel paper or an instrument and "intangible" means all personal property, including choses in action, that is not goods, chattel paper, documents of title, instruments, money or investment property.

[3] It can take up to 24 hours for the deed of hypothec to be registered by the RPMRR.

[4] Also referred to as unlimited companies or unlimited liability corporations, depending on the particular statute.

[5] As of the date of this article, ULCs may be incorporated under the *Business Corporations Act* (British Columbia), *Business Corporations Act* (Alberta), *Companies Act* (Nova Scotia) and the *Business Corporations Act* (Prince Edward Island).

[6] *Solar Power Network Inc. v. ClearFlow Energy*, 2018 ONCA 727.

[7] Business corporations may be incorporated federally under the *Canada Business Corporations Act* (the CBCA) or provincially/territorially (e.g., under Ontario's *Business Corporations Act*).

[8] See, for example, section 186 of the CBCA.

[9] *R.E. Lister Ltd. v. Dunlop Canada Ltd.*, 1982 CanLII 19 (SCC), [1982] 1 SCR 726.

[10] The secured creditor must send the notice of intention in the form prescribed under the BIA.

[11] *Séquestre de Media5 Corporation*, 2020 QCCA 943.