Lending in Canada

Key Issues for Foreign Entities

By Kevin Morley

OSLER

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Introduction

The Canadian lending market offers a wide breadth of traditional and alternative opportunities for foreign banks and lending institutions to invest in. Whether operating as "foreign banks", as branches or subsidiaries of Canadian banks, or as other credit providers, foreign investors are perfectly poised to reach Canadian borrowers.

This report examines how the Canadian regulatory and legislative landscapes differ from those in the U.S. and informs readers on how to best navigate these areas while remaining mindful of key legislation, such as the federal *Bank Act*.

Parts

1

Canadian Bank Regulation

The Canadian banking industry is made up of both domestic and foreign banks, with a few large domestic banks accounting for the majority of banking activities carried out in Canada. The operation of these banks is governed by the federal *Bank Act*, which requires that a bank receive authorization to carry out banking activities. Banks are classified into one of three schedules of the *Bank Act* and the classification determines which provisions of the Act apply to a particular bank. Canadian owned banks, which include Canada's largest banks, fall under Schedule I. Foreign bank subsidiaries are classified as Schedule II banks and foreign banks operating through branches in Canada are classified as Schedule III banks. The *Bank Act* contains an expansive definition of a "foreign bank," and both the parent bank and all of its controlled entities are generally captured by the definition.

The principal provision that applies to foreign bank activities in Canada is contained in subsection 510(1) of the *Bank Act*, which states:

> "… a foreign bank or an entity associated with a foreign bank shall not
> (a) in Canada, engage in or carry on (i) any business that a bank is permitted to engage in or carry on under this Act, or (ii) any other business; … or
> (d) acquire or hold control of, or a substantial investment in, a Canadian entity."

An exception to the above rule exists under section 524, which allows foreign banks to establish a branch in Canada upon approval from the Office of the Superintendent of Financial Institutions. As a result of the prohibition described above, foreign banks can arrange their operations in one of two ways: (i) by establishing a presence in Canada as a foreign bank subsidiary or as a foreign bank branch; or (ii) by structuring their activities so as not to be considered to be carrying on business in Canada and therefore not violating subsection 510(1) of the *Bank Act*.

If a foreign bank wishes to avoid the application of the *Bank Act* while making loans to Canadian-based borrowers, it must ensure that it will not be considered to have engaged in or carried on a business in Canada. This determination is generally a question of fact and considers such factors as whether a location of business exists in Canada, whether there are employees in Canada, whether the foreign bank maintains an account in Canada (with or without daily clearing of such account), where documentation is negotiated and executed, and which law governs the executed documentation. Further factors might include where loan advances are made and repaid (i.e., does the foreign bank maintain deposits or accounts in Canada?) and the nature and frequency of its employees' visits to Canada (for marketing, collateral audits and the like).

Generally, foreign banks that do not show any Canadian connection can avoid the finding that they have carried on or engaged in a business in Canada. However, as noted above, this is entirely a matter of fact that depends on each individual situation.

If a foreign bank chooses to structure its operations in such a way as to avoid the application of the *Bank Act*, it will lose its ability to take advantage of several Canadian security-granting statutes, including the taking of the *Bank Act* security, discussed further below.

The following discussion describes certain important legal considerations for foreign lenders that intend to lend to Canadian debtors.

If a foreign bank chooses to structure its operations in such a way as to avoid the application of the *Bank Act*, it will lose its ability to take advantage of several Canadian security-granting statutes…

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Taking Security in Canada

The taking and perfecting of security in Canada is substantially governed by provincial rather than federal laws as property and civil rights are constitutionally reserved to the provinces while the regulation of banking and of intellectual property is reserved to the federal government. As a result, in contrast to the U.S. Uniform Commercial Code (UCC), the regime in Canada for taking security differs between provinces and has an additional lien system at the federal level for certain types of security or collateral. Although most of the provinces, including Ontario, have security laws and procedures largely similar to those in the UCC, other provinces, such as Québec, differ in procedure.

Additionally, the Canadian regulatory scheme dealing with the taking, perfecting and enforcing of security interests may be governed by several different acts without clear rules of exclusivity over a specific type or set of security. In short, searches concerning security registrations must be carried out across a number of acts and jurisdictions with no single central system that may reveal all security interests in a single item of property. It is generally not sufficient to simply conduct *Personal Property Security Act* (PPSA) searches. There is not yet an equivalent to article 9 of the UCC that provides for centralized searches and filings in the jurisdiction of the chief executive office. Likewise, no single set of rules exists for the determination of priorities between interests created under the different acts. While this gives rise to the cumbersome need to conduct searches and make filings on a province-by-province basis, the substantive result, including in Québec, is not materially different from that in the United States once one accounts for the mechanical differences.

Two of the most common types of security interests that may be granted in Canada are governed by each provincial PPSA and through the federal *Bank Act*. Both of these are discussed in more detail below.

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SECURITY UNDER THE *PERSONAL PROPERTY SECURITY ACT* (ALL PROVINCES EXCEPT QUÉBEC)

The general rules related to the taking of a security interest in personal property are regulated by the provincial PPSAs. The term "security interest" is broadly defined and, as set out in the Ontario PPSA, is intended to capture "an interest in personal property that secures payment or performance of an obligation." While there are slight variances across the provinces, the Ontario act provides a typical definition of the term "personal property":

> 'personal property' means chattel paper, documents of title, goods, instruments, intangibles, money and investment property, and includes fixtures but does not include building materials that have been affixed to real property. **[Section 1]**

Typically, registration is effected by the filing of a PPSA financing statement and the perfection of the security interest is carried out through registration, possession or effective control of the collateral. Two steps must be carried out to create a perfected security interest that is enforceable against third parties. First, the security interest must attach to the collateral. This means that value must be given, the debtor must have rights or the power to transfer rights in the collateral, and a security agreement must have been executed. Second, there must be registration, possession or effective control of the collateral. Registration is the most common of the three and is typically effected by the filing of a PPSA financing statement. Unlike the UCC, registration will perfect in accounts and money without specific control agreements, although there is additional protection afforded by such control agreements.

Notably, the PPSAs allow lenders to take a general security interest in all of the debtor's existing and after-acquired assets. However, such an interest would not include an interest in the debtor's real estate.

With regard to priorities, the PPSAs typically follow a "first in time, first in right" scheme. Subsequent taking of interests may be managed through the provision of "estoppel statements" from existing lenders who have not described their collateral narrowly enough to limit what is covered by their filings. Such estoppel statements provide comfort to subsequent lenders by providing a voluntary representation and warranty that additional property will not be included under a previously registered financing statement. Once again, since the UCC does not, like Ontario, allow "check the box" financing statements (and we note that, unlike the UCC, financing statements are not required to be authorized or signed by debtors), this extra task of obtaining estoppel letters does add some additional time and costs.

...managed through the provision of "estoppel statements" from existing lenders who have not described their collateral narrowly enough to limit what is covered by their filings.

Finally, there is no requirement to possess certificates of title for collateral such as motor vehicles in order to perfect on such collateral. Rather, the various PPSAs provide for vehicle identification and/or serial number goods filings.

As with the UCC, there are requirements to record transfers of collateral and debtor name changes within prescribed time periods.

SECURITY UNDER THE FEDERAL *BANK ACT* (SECTION 427)

Banks in Canada may avail themselves of a specific type of interest-granting scheme under section 427 of the *Bank Act*. Borrowers that may be subjected to the *Bank Act* security must be identified in one of the classes specified by the act, which include wholesalers, retailers, manufacturers, shippers of goods, farmers, fishermen and forestry producers.

Registration takes place through the filing of a "Notice of Intention to Grant a Security Interest" with a federal ministry in the jurisdiction of the debtor's principal location of business. A single registration of the *Bank Act* security will be valid across the entire country.

While the *Bank Act* security can lead to some complications in the determination of priorities among financial institutions and other creditors taking security under provincial acts, pre-closing searches generally resolve most issues that might cause concern for new financers.

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Taking Security in Specific Types of Assets

Specific types of assets, which are typically pledged as collateral in lending transactions, merit additional consideration.

COMPANY SHARES AND THE *SECURITIES TRANSFER ACT*

The transfer of property interests in securities is governed by each provincial *Securities Transfer Act* (STA), which must be considered in the context of pledges of company shares. The STAs dictate the way that certificated and uncertificated company securities can be transferred. These acts also create certain distinctions between the direct and indirect holdings of securities. Generally, a secured party may perfect its security interest in a certificated security by taking delivery of the actual share certificates. The registration of the lender as owner of securities in the issuer's register is typically carried out to perfect a security interest in uncertificated shares. Such practice is quite common for share pledges by private companies.

Control over the shares appears to be a determining factor for perfection of interests in all types of securities and it becomes increasingly important for indirect holdings. Control, therefore, creates a perfected security interest that trumps registration. For this reason, it has become common practice for lenders to obtain both control and registration as part of accepting pledges of securities from debtors.

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PLEDGING ULC SHARES

Provincial corporate statutes in Nova Scotia, Alberta and British Columbia allow for the creation of unlimited liability companies (ULCs). Traditionally, ULCs were utilized by cross-border lenders in effective tax planning since these corporations could be used as flow-through entities for U.S. tax purposes. While recent tax changes have significantly curbed the use of new ULCs in U.S.-Canada cross-border lending transactions, they remain commonplace and must be scrutinized by existing and prospective lenders. ULCs expose their shareholders to unlimited liability. As a result, secured lenders taking a pledge of ULC shares would, in certain instances, become exposed to the underlying shortfalls or obligations of the ULC. Secured lenders must be diligent in the structuring of the relevant share pledge agreement so as to minimize the possibility of being considered a shareholder of the ULC. They may also be interested in reserving a right to such a determination at a different time – that is, when the secured creditor may wish to exercise the remedies available to it. So, for example, the pledgee will not typically take any rights to dividends or to vote the shares prior to enforcing and taking actual control.

DEPOSIT ACCOUNTS

The current PPSA regime allows for the taking of security in debtors' deposit accounts. Thus, it is common practice to register PPSA financing statements with respect to the debtor's deposits registered with a deposit-taking financial institution. While not necessary for perfection, asset-based lenders also typically require control agreements on deposit accounts.

GOVERNMENT ACCOUNTS

Debts owed by the federal government and by the government of Alberta may not be granted as a security and may only be transferred outright through an assignment unless otherwise made assignable by exceptions of the applicable public authority in question. The process is quite cumbersome and uncertain. As a result, lenders have conventionally excluded federal and certain provincial government receivables from their borrowing bases. Specific attention must be paid to the definition of "government" and "Crown" accounts because certain entities labelled as such may not be easily identifiable.

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REAL PROPERTY

Since a wide range of liens may be granted over real property, lenders in Canada have traditionally relied on title legal opinions to ensure clear title to real property. Lenders may require their legal counsel to conduct all necessary searches, assure them that the real property is free from unknown security interests and confirm that title to the property is valid and in good standing. An alternative to such an opinion comes in the form of obtaining adequate title insurance, which has been a growing practice in recent years.

PERSONAL PROPERTY

As is typical in the United States, Canadian counsel generally do not opine on title to any personal property, and borrower counsel's opinions are restricted to the enforceability and validity of loan and other corporate documents.

INTELLECTUAL PROPERTY

While the regulation of intellectual property in Canada falls within federal jurisdiction, no federal law expressly permits the granting of security interests in copyrights, trademarks or patents. Existing acts allow merely for the registration of an assignment. As a result, lenders have generally taken the position that, to effectively protect their lending base, steps should be taken to perfect an interest through the provincial PPSAs and to file an appropriate notice of interest with the federally regulated Canadian Intellectual Property Office.

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Additional Considerations Concerning Taking Security in Canada

UNREGISTERED AND SUPER-PRIORITY LIENS

Compared to its U.S. counterpart, Canadian law allows for a significantly larger number of statutory liens that, even when not registered, may take priority over all other security interests. Such liens are often granted to the government as a way to collect unremitted fines or deductions, such as employee deductions for income tax or unpaid property taxes.

The existence of such liens must be taken into consideration early on in the process of taking a security interest in the debtor's property. These liens may not be identified through a conventional search because they are created by way of deemed trusts that are not registered. Please see Schedule A to this guide for a general discussion of Canadian priority liens and reserves against borrowing bases.

LOCK BOXES AND ACCOUNT CONTROL AGREEMENTS

Lock boxes are not typically used in Canada. Instead, lenders have traditionally used blocked account arrangements for lending purposes. Note that, unlike under the UCC, there is no requirement to use blocked accounts to obtain "perfection" in Canada.

Lock boxes are not typically used in Canada.

PENSION PLAN CONTRIBUTION LIENS

Under the *Bankruptcy and Insolvency Act of Canada* (BIA), certain unpaid pension plan contributions and potentially all the underfunded liabilities in wound-up defined benefit pension plans may receive priority over other secured interests. The Supreme Court of Canada decision in *Indalex Limited (Re)* regarding Ontario defined benefit plans has added uncertainty about the relative priority of the lien for the deficiencies upon wind up of defined benefit pension plans. The Ontario Court of Appeal recently considered that decision in *Grant Forest Products Inc. v. The Toronto-Dominion Bank.*

For more information on *Indalex* and *Grant Forest* and the implications for lenders, please see Schedule B to this guide, which includes a recent article on the topic by Kevin Morley.

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Law in Québec

Québec, being Canada's only civil law jurisdiction, has a *Civil Code* that codifies that province's laws. Unlike the PPSAs that operate on the basis of "security interests" created by general security agreements, in Québec, hypothecs are granted to secure obligations. These hypothecs, like general security agreements, may charge present and after-acquired movable (i.e., personal) property or immovable (i.e., real) property. Hypothecs are recorded in a central registry similar to the PPSA filing system. As a result, while there are technical and procedural differences, for all practical purposes, creditors can readily obtain property liens on Québec assets.

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Asset-based Lending in Canada

Numerous additional considerations apply to foreign asset-based lenders in Canada, including the following:

INTEREST RATE DISCLOSURE AND CRIMINAL RATE OF INTEREST

While the federal *Interest Act* permits lenders to charge any rate of interest, it imposes an obligation to disclose an equivalent annual rate of interest. If such disclosure is not made, a rate will be imposed that could affect the lender's enforcement rights.

In addition, the *Criminal Code* of Canada prohibits the charging of annual interest that exceeds 60%. Any rate above 60% is labelled a "criminal rate" and is therefore illegal. Debtors may use such a finding as a reason to avoid repayment. It is noteworthy that "interest," as defined in the *Criminal Code*, includes all ancillary charges such as fees, fines, penalties and commissions.

INTERCORPORATE GUARANTEES

Canadian law looks much more favourably at intercorporate guarantees than does U.S. law. Canadian corporate statutes generally permit most forms of intercorporate guarantees as long as adequate disclosure is made to the shareholders. Nonetheless, fraudulent preference/conveyancing provisions under the BIA and under a variety of provincial statutes, and solvency tests under the corporate statutes of a number of provinces must be met by companies taking into account such financial assistance. Furthermore, any guarantees that may unfairly prejudice minority shareholders or other stakeholders may be challenged in court.

ENVIRONMENTAL LIABILITY

Canadian environmental law comprises a collection of federal and provincial statutes that impose significant obligations on the operations of certain companies. As a result, lenders must be mindful of the various environmental liabilities and reclamation obligations that will apply to their debtors and could, under certain circumstances, extend to the lending entity. If the lender is found to have exercised control or direction of their contaminating debtor, environmental liability may be shared by both companies. The statutes do not allow for the levying of fines on creditors holding a mere security interest in the assets of an infringing debtor.

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Enforcing Secured Creditor Interests in Canada

The two most relevant statutes concerning the enforcement of secured interests in Canada are the *Companies' Creditors Arrangement Act* (CCAA) and the BIA. These acts are federal and, therefore, the basic legal scheme of creditor enforcement is largely similar across all the common law provinces. The process deviates slightly in the province of Québec, although it achieves largely similar results.

Creditors may attempt to recover assets from debtors by either initiating a restructuring process or through more traditional enforcement means. The discussion below specifically concerns debtors who are "insolvent" – generally meaning that they are unable to pay their debts or have ceased to do so when their debts are due, or the value of their combined property is less than their liability.

As with other parts of this guide, the discussion below should be treated as a basic overview and should provide the reader with an appreciation for the complexity of the enforcement process. Overall, it becomes clear that, in its quest to enforce a secured obligation, the creditor is faced with several different alternatives, each with a unique set of advantages and drawbacks. For this reason, creditors in Canada can benefit greatly from selecting legal advisors who are experts in the field and have experience in all forms of creditor- and debtor-initiated enforcement procedures.

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RESTRUCTURING PROCESSES

Several different restructuring processes are available under the two major Canadian restructuring and insolvency acts.

CCAA Proceeding

A popular form of restructuring in Canada involves a creditor-sponsored CCAA process. Either a creditor or a debtor may apply to a court under the CCAA to temporarily freeze all pending enforcement procedures and to allow the indebted company to restructure its operations in order to emerge as a non-insolvent enterprise. The court must approve the process and, typically, does not look favourably at such restructurings in cases where the opportunity to restructure is not at least a possibility, however unlikely.

The CCAA process allows debtors to retain control of their business while they attempt to negotiate their indebtedness with all creditors. Creditors are typically afforded a vote over any settlements on a class-by-class basis. The classes are determined by the court on the basis of a commonality of interests. The process is not confined to statutory provisions and is much more flexible than its equivalent counterpart in the United States. As a result, the court appoints a "monitor" who oversees the process, ensures effective communication and, in some instances, takes on more substantive tasks akin to a "receiver," as described below. The choice of an effective and competent monitor is an essential part of the process.

In certain instances, and as negotiated by the parties, the CCAA process may turn into a liquidation, whereupon the creditors become entitled to the proceeds of the disposition of all the debtor's assets. Such dispositions are statute prescribed and court supervised. The conditions that trigger the liquidation are left up to the negotiating parties. These CCAA sales are far more flexible than are "363 sales" under the *U.S. Bankruptcy Code*.

Although this process is somewhat costly and sometimes lengthy, it is generally shorter and less costly than a comparable "Chapter 11" process and it is far more flexible. As a result, it is often the preferred type of enforcement procedure in complex bankruptcy or insolvency situations.

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BIA Proposal

The BIA features a restructuring procedure that is conceptually similar to its CCAA counterpart. Unlike the CCAA process, which may be started by either the creditor or the debtor, the BIA proposal may only be initiated by a debtor. The BIA-governed procedure is much more rigid than its CCAA alternative, although the basic underpinnings are largely similar. A stay of proceedings is granted, a "proposal trustee" is appointed with a role similar to the monitor's role, and debtors are expected to work out a compromise with their creditors. Creditors in this process also get a vote.

Unlike under the CCAA, the proposal must be presented within a prescribed period of time – typically 30 to 45 days. Traditionally, restructuring parties have preferred the CCAA process over the BIA proposal because of the flexibility the CCAA affords to all parties. However, the BIA proposal has been a procedure of choice in specific complex situations since, in rare instances, it provides creditors with an ability to obtain more favourable settlement outcomes.

Bankruptcy under the BIA

A creditor may make an application in court to issue a bankruptcy order against a debtor. The debtor may concede or object, in which case a court hearing will take place to determine whether an "act of bankruptcy" has occurred. A debtor's inability to meet debt obligations is within the purview of such acts of bankruptcy although, for a secured creditor to make an application for a debtor's bankruptcy, certain other conditions must be met.

Once a bankruptcy order is granted, the court appoints a "bankruptcy trustee" that oversees the disposition of the debtor's assets. The bankruptcy trustee's fees are generally paid out of the debtor's estate or through an indemnity from the creditors. The bankruptcy procedure under the BIA allows secured creditors to retain their security interests and may be beneficial insofar as it allows certain statutory liens, such as those discussed in Part IV, to become subordinated. As with all other enforcement procedure supervisors, the choice of an effective bankruptcy trustee is a crucial aspect of the process.

As is noted in the article attached as Schedule B, the filing of a bankruptcy petition, and the timing thereof, to effectively alter priorities (in favour of the secured creditors) is a very contentious issue in Canadian jurisprudence, particularly following the Indalex decision in regard to deficits existing in wound up defined benefit pension plans.

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TRADITIONAL ENFORCEMENT PROCEDURES

The discussion below outlines the steps involved in the traditional process that must be undertaken by a secured creditor to recover collateral or realize on debts owed.

Demand for Payment

Although loan documents generally govern the way default is defined, Canadian law requires that a demand for payment be made to a debtor as the first step in the enforcement process.

Debtors are required to be given a reasonable period of time to cure their default, which is a factual determination in all the circumstances.

When the debtor is insolvent and enforcement over all of its assets is contemplated, the BIA requires that the creditors provide a 10-day notice of intent to enforce their security, which is usually then considered the "reasonable time to pay." Such conditions cannot be waived by any debtors prior to insolvency.

Appointment of Interim Receiver

An "interim receiver" may be appointed to ensure that the insolvent debtor's assets are appropriately preserved. An interim receiver may only be appointed through the courts and typically remains in place for a period of 30 days. The interim receiver's primary task is to ensure that the main assets of the debtor that are subject to security interests – namely, the accounts receivable, inventory and other operational assets – remain in place and in good condition during the enforcement process.

As mentioned, a court application must be brought to appoint an interim receiver. While there is no requirement for a significant notice period, the creditor must prove that there is a real need for court oversight over the protection of the debtor's assets. Creditors participate in the important decision of choosing the interim receiver and, in Canada, such positions have traditionally been filled by restructuring experts working in specialized restructuring firms or in major accounting firms. The interim receiver's fees may be covered by the creditors. Alternatively, to cover the fees, the interim receiver may be granted a lien over the insolvent's assets that ranks in priority to other security interests.

REVIEWING ENFORCEMENT OPTIONS

If the debtor fails to cure the event of default, secured creditors must carefully consider the several different enforcement options available to them.

Taking Possession Outside of Court

When provided for in the security documents, creditors may employ private means to take possession of the debtor's assets. Most commonly, this is accomplished by hiring a private receiver. Such a method may interfere with the debtor's ongoing operations and will involve additional costs for the creditor. It is important to note that this method is not recommended for creditors whose security interest may be ranked behind others or if there are other significant stakeholders such as unions or multiple landlords whose interests have to be considered. The proceeds from the seized assets will have to be shared with, and perhaps passed entirely on to, the higher-ranking creditor.

If the debtor fails to cure the event of default, secured creditors must carefully consider the several different enforcement options available to them.

Taking Possession Through the Courts

Creditors may seek the appointment of a receiver through the court system. The role may be exercised by an interim receiver if one is in place or by a newly appointed restructuring specialist. The receiver is appointed by the court and has a judicially defined mandate, which is typically tailored to the specific situation. Court-appointed receivers are generally appointed to take control of the majority of the debtor's assets rather than confiscate a specific class or subset of assets. Receivers may also displace the management and take control of the business. Similar to the situation with interim receivers, court-appointed receivers are paid by either the creditors or through a lien granted over the assets under their control. For this reason, when specific creditors have a priority interest over all the debtor's assets, they will ultimately bear the costs of the court-appointed receiver. The choice of the appropriate receiver in such situations is crucial due to both the high level of expertise required and the significant fees involved.

Realizing Value in the Possessed Collateral

Once possession of the collateral is obtained, the creditor has several different options for realizing value and recovering the debtor's obligations.

Private Sale

The provincial PPSAs, like the UCC, dictate minimum requirements for the sale of the collateral through private means, either by the creditor itself or through a privately appointed receiver. The sale must typically be carried out on commercially reasonable terms and written notice must be given to other parties that may have an interest in the asset. The costs of disposition are generally covered by the proceeds ahead of other security interests.

Foreclosure

Secured creditors may choose to keep the possessed assets in satisfaction of their security interest. As with the private sale, notice must be provided to other parties that may have an interest in the collateral and such other creditors have a right to object. If other creditors object within a prescribed time period, the foreclosed collateral must be sold.

Regardless of the value of the collateral, when a secured creditor exercises the option to foreclose, the creditor relinquishes all other claims against the debtor.

Court-Supervised Sale

When a court-appointed receiver chooses to sell the repossessed assets, each sale of significant assets must typically go through a court approval process. The proceeds are applied first to costs of disposition and then divided between the secured creditors. In such a process, the sale typically takes a much longer time since fairness of the process must be established before the court. In certain instances, an auction must be conducted. The receiver's duties in the process are to all creditors and the court undertakes a four-step analysis prior to approving the sale:

1. Whether a process to obtain the best price has been instituted;
2. How the sale will affect the interests of all parties;
3. The effectiveness of the sale process; and
4. Any unfairness to the affected parties resulting from the sale.

Schedules

A

Canadian Priority Claims, Payables and Reserves

The following is generally the minimum range of priority payables and reserves which would be considered in an "asset-based" lending agreement in Canada. The suggested "Reserves" are general comments and each situation is typically considered on its merits, including having regard to strength of credit and flexibility to implement additional reserves if the credit becomes stressed.

A. SOURCE DEDUCTIONS

- INCOME TAXES owing by employees that have been deducted from wages but not yet remitted
- EMPLOYMENT INSURANCE premiums of employees that have been deducted from wages but not yet remitted
- CANADA PENSION PLAN (CPP) (OR SIMILAR PROVINCIAL PLANS SUCH AS CURRENTLY CONTEMPLATED IN ONTARIO) contributions of employees that have been deducted from wages but not yet remitted and employer contributions that are due and owing

Priority – super-priority

Reserve – provided are current, average amount remitted for one remittance period

B. WEPPA – BIA (WAGE EARNER PROTECTION PROGRAM ACT)

- $2,000/employee for wages, salaries, commissions or other compensation (excluding insurance and severance but including vacation pay) incurred during the six months prior to the bankruptcy (include an additional $1,000 for travelling salespersons)

Priority – super-priority

Reserve – $2,000/employee plus $1,000 for travelling salespersons. If significant numbers of part-time employees may consider less than the $2,000 per employee

C. SEVERANCE/TERMINATION

- Only for severance or terminations which preceded the receivership or bankruptcy
- No priority for terminations or severance as a result of or following the receivership or bankruptcy

Priority – only as noted above

Reserve – rarely any material unpaid severances preceding receivership or bankruptcy

D. PENSION CONTRIBUTIONS OTHER THAN CPP OR SIMILAR PROVINCIAL PLANS

- Normal (monthly) contributions (unpaid) and contributions deducted from employees' wages and not yet remitted

  Priority – super-priority

  Reserve – provided no arrears, average monthly amount (since typically paid monthly in arrears). Consider larger reserve if large unfunded liability as a "practical priority" since the liability will have to be amortized in future

- Reserve for some or all of the unfunded liability upon wind up of a defined benefit plan per *Indalex*?

E. TAXES

- GST – Goods and Services Tax

  Priority – super-priority in bankruptcy if garnishment notice delivered prior to bankruptcy

  Reserve – average net payable for one remittance period is generally the amount reserved (if at all)

- PST – Provincial Sales Tax

  Priority – no super-priority in bankruptcy, other than by registered lien subject to prior filings

  Reserve – none typically as would be reversed in priority upon a bankruptcy

- HST – Harmonized Sales Tax – a federally collected tax combining the PST and GST for the provinces of Ontario, Nova Scotia, New Brunswick and Newfoundland

  Priority – super-priority, as per GST above

  Reserve – average payable for one remittance period

F. WORKERS' COMPENSATION

Priority – none, other than by registered lien subject to prior filings (for contribution unremitted)

Reserve – none typically

G. UNPAID SUPPLIERS – 30 DAY GOODS

- Farmer, Fisherman and Aquaculturists

  - repossession rights to goods supplied within 15 days prior to bankruptcy

  Priority – super-priority right (in bankruptcy) to repossess ahead of all creditors AND super-priority traces into receivables if goods sold. No general *Perishable Agricultural Commodities Act* (PACA) laws, but may be special protection for the suppliers of certain commodities on a province-by-province basis

  Reserve – amount to be determined on a case-by-case basis

- All other Trade Suppliers

  - repossession rights to goods supplied within 30 days prior to bankruptcy

  - repossessory conditions difficult to meet (identifiable, traceable, separated, same state, etc.)

Priority – super-priority right (in bankruptcy) to repossess ahead of all other creditors; however, not generally effective in a CCAA or BIA restructuring (i.e., cannot repossess during a Stay of Proceedings and goods generally turn over as receiver/company continues to run business during Stay). Unlike Farmers, Fishermen, etc., priority does not attach to proceeds or receivables

Reserve – market practice is not to reserve based on limited chance of success of trade supplier's claim (stayed by a restructuring proceeding, for example). Suggest a legal discussion on a case-by-case basis

H. LANDLORD DISTRAINT RIGHTS

Reserve – market practice is two to three months' rent if have not received a Landlord Waiver

Note: no landlord lien in Québec unless landlord has registered a hypothec

I. INDUSTRY RESERVES

- Special Bankruptcy and Insolvency Act rights for unpaid farms and fishermen.
- Forestry/Fishing – fisher's liens, loggers, tug boats, etc.
- Trucking/Load Brokers – *Highway Traffic Act* (Ontario)
- Construction
- Repairer/Storer

Priorities and Reserves – discuss on a case-by-case basis with counsel to determine state of law and exposure

Note: Crown (Federal and Alberta) receivables are not generally assignable

The foregoing is for general informational purposes only and does not constitute legal advice.

B

Indalex Pension Decision Considered by Ontario Court of Appeal

Following the Supreme Court of Canada decision in ***Sun Indalex Finance, LLC v. United Steelworkers***, [2013] 1 S.C.R. 271 ("***Indalex***"), creditors and their advisors have been closely following jurisprudence which considers the scope of that decision.

On Friday, August 7, 2015, the Ontario Court of Appeal released its much-anticipated decision in ***Grant Forest Products Inc. v. The Toronto-Dominion Bank***. As discussed below, this decision represents a clear narrowing of some of the broader interpretations of *Indalex*. Holders of pre-filing liens that would be concerned that, unlike debtor-in-possession financers, they would not enjoy the application of federal paramountcy during a CCAA proceeding to rank ahead of a deemed trust (a "**wind up deemed trust**") arising upon a wind-up of a defined benefit pension plan (a "**DB Plan**") will take comfort from the clear holdings by the Court of Appeal that

- a wind up of a DB Plan after the initial CCAA order will not result in a wind up deemed trust having priority over the pre-filing liens (i.e., only DB Plans wound up before that date need be a concern); and
- the court continues to have a discretion to lift a CCAA stay to permit a *Bankruptcy and Insolvency Act* (Canada) (the "**BIA**") filing, and that it is not inappropriate, and is not in bad faith, for a creditor to request that relief even if the purpose is to reverse the priorities through the application of the doctrine of federal paramountcy.

OVERVIEW

Following a petition filed by a creditor under the BIA, Grant Forest Products Inc. and certain affiliates obtained protection under the *Companies' Creditors Arrangement Act* ("**CCAA**") and stayed the BIA petition. Following an unsuccessful effort to market the business as a going concern, the companies entered into a liquidation process. There was no debtor-in-possession financing arrangement. After selling assets and paying out the first lien lenders, there were insufficient funds to satisfy the claims of the second lien lenders and claims in connection with two DB Plans which were wound up by the Ontario Superintendent of Financial Services (the "**Superintendent**") during and before completion of the liquidation of assets but after the initial CCAA order.

The CCAA judge on application of a second lien holder (who sought to be substituted for the original petitioner under the BIA or a lift of the stay of proceedings to permit it to petition the companies into bankruptcy) ordered the debtor companies into bankruptcy at the end of the liquidation process, and then determined that, under the BIA scheme of priorities, the second lien holders had priority over the wind up deemed trusts arising upon the windup of the DB Plans.

The Superintendent appealed, relying upon the Supreme Court of Canada decision in *Indalex*. The Superintendent argued that by virtue of Sections 57(3) and (4) of the *Pension Benefits Act* (Ontario) and Section 30(7) of the *Personal Property Security Act* (Ontario), the wind up deemed trust had priority. Representative counsel to active and retired employees of United States Steel Canada Inc. intervened in the appeal to argue that the *Indalex* decision means that the wind up deemed trust has priority over all secured creditors since pension benefits are a form of deferred compensation for employee's service and that the CCAA judge wrongly caved into the lender's threats that their credit would be restricted if secured creditors were not ranked ahead.

The Court of Appeal dismissed the appeal.

REASONING

The CCAA judge noted in his decision that (as opposed to a rush to bankruptcy by creditors concerned upon wind up deemed trusts) the CCAA proceeding provided the widest benefit to all stakeholders, whereby some assets were sold as going concern which provided employment and benefits to many, whereas an immediate bankruptcy might have resulted in lower recoveries for creditors and certain loss of employment. He found that the wind up deemed trust would prevail only when wind up occurs before insolvency and not when a wind up is ordered after the initial order in the CCAA proceeding. He further relied upon *Indalex* for the proposition that provincial/statutory provisions in the pension area prevail prior to insolvency but once the federal statute is invoked, the insolvency regime applies.

Further, the CCAA judge observed that it is a discretionary decision whether to terminate a CCAA proceeding and permit a bankruptcy petition to proceed. The question is whether it is fair and reasonable, bearing in mind the interests of all creditors, that the interests of the creditor seeking preference under the BIA should be allowed to proceed. There was no evidence of a lack of good faith on the part of the second lien creditors in seeking to lift the stay.

The CCAA judge specifically noted that the Supreme Court in *Indalex* limited the wind up deemed trust to obligations arising prior to bankruptcy and rejected that bankruptcy applications would be at odds with the *Indalex* decision.

The Court of Appeal confirmed that the lifting of the stay to permit bankruptcy is a discretionary decision and found no error in principle, or that the CCAA judge's exercise of his discretion was unreasonable since liquidation was complete and the bulk of sales proceeds had been distributed. There was nothing left to reorganize or restructure. The Court of Appeal reconfirmed that a creditor is entitled to seek a bankruptcy order in order to reverse priorities and that once the bankruptcy order was made, the federal BIA scheme of priorities prevails over the provincial priority.

While the Court of Appeal did not curtail the broad finding in *Indalex* that a wind up deficiency under an Ontario DB Plan gives rise to deemed trust ranking, outside of bankruptcy, in priority to secured liens on certain collateral, the Court of Appeal distinguished the facts and issues in *Indalex* as there was no wind up of a DB Plan prior to the commencement of CCAA proceedings and the BIA played no part in *Indalex*, but in this case a bankruptcy petition had been initiated before the CCAA proceeding.

AUTHOR

Kevin J. Morley
Partner, Financial Services

kmorley@osler.com
416.862.6488

Kevin Morley is a senior partner in Osler's financial services practice and has represented creditors for more than 25 years.

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