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True sale or not true sale

By Neill May

That there is uncertainty as to what constitutes a "true sale" should come as no surprise. In my personal life, there are stereotypical debates about the benefits of retail bargains that are "on sale." Having studied economics, I expect that every decision each of us makes in our lives is a "true sale," made with full information and without coercion; otherwise, we would not do it — the kind of Economics 101 conclusion that seems pretty obvious and leaves one no further ahead. So, the fact the law has not neatly settled the question is foreseeable.

In fairness, the simplicity of the "true sale" label belies the complexity of the transactions where the question arises. At its core, the issue generally boils down to whether the transaction in question was a "true sale" of an asset or some form of financing transaction, and tends to arise either in the context of commercial disputes about competing interests in the asset or as part of sophisticated tax structuring. The recent British Columbia Supreme Court decision in *Coutinho & Ferrostaal GmbH v. Tracomex (Canada) Ltd.* is an interesting example of the former.

Tracomex, similar to the other few Canadian cases on the point, involved a repurchase option. In the case, Trac Chile purchased some used train rails for approximately $1.2 million, payable in instalments. Trac Chile then entered into an agreement to sell the rails to a third party, Imbamar, for approximately $460,000. At the same time, Trac Chile acquired an option to repurchase the rails from Imbamar in 180 days for approximately $550,000 (which would represent a 20-per-cent return for Imbamar). The various litigants' competing commercial claims raised the question of whether the transaction between Trac Chile and Imbamar was a genuine sale by Trac Chile (as the transaction documentation suggested) or whether the arrangement was actually a financing deal.

Although there have been few decisions directly on point, the courts have provided some guidance (I am not going to disclose where the court came out on *Tracomex* just yet, to maintain the suspense and so you can play along at home). The Supreme Court of Canada has stated:

- the starting point for characterization of an instrument or transaction is the intention of the parties, objectively determined, by looking first to the transaction documents and, if they are not sufficient, at surrounding circumstances (*Canada Deposit Insurance Corp. v. Canadian Commercial Bank*); and
- as a general rule, courts should only re-characterize the legal nature of a transaction or instrument if the label attached to it by the parties does not properly reflect its actual legal effect (*Shell Canada Ltd. v. Canada*).

Those types of general principles are helpful, but they only take you so far. Clearer guidance on "true sale" characterization is provided in the trial decision in *Metropolitan Toronto Police Widows and Orphans Fund v. Telus Communications Inc.*, which dealt (in a portion of the decision essentially undisturbed on appeal, and in a case involving a repurchase option) with the criteria a court should consider when determining whether a transfer of financial assets is a "true sale." Notably, and logically, those criteria include consideration of whether the risks of ownership of the asset transferred to the putative buyer.

The *Telus* decision also noted that courts should look at the "substance" of the transaction. This comment is potentially confusing, since it would seem to invite a court to "look through" the legal form that the parties have chosen to document their transaction to discern the underlying "economic substance" — an approach commonly taken under U.S. case law. However, Canadian courts have consistently interpreted "substance" much more narrowly to mean "legal substance": that is, whether the agreement as documented actually effects the legal results that it purports to effect. This is a headache to consider, but it is a critical point, particularly for tax-structured transactions, which are often intentionally designed on the basis of different jurisdictional approaches to characterization.

In *Tracomex,* the agreements on their face, though cast as sale documents, reflected an intention to consummate a financing. Both the sale price and the repurchase price were at very significant discounts to market value — it was not foreseeable that the vendor would not in the normal course exercise its repurchase option (though it did not do so for unrelated reasons). In fact, the repurchase price was clearly based on an interest calculation (a relatively attractive one, at 20 per cent over six months). The court also considered pre-contractual communications between the parties, which referred to the transaction as a financial deal and used language, and considered concepts (such as a prepayment penalty), more consistent with financings than asset sales.

The apparent state of the law in Canada is that if parties to a transaction objectively intend to consummate a sale transaction and the documentation and interactions objectively reflect that intention, then the form will be respected by the courts. This is different from the U.S., for example, where I understand that the courts will look at the commercial effect of the transaction in characterizing it. And different still from my family, where the rules have the benefit of clarity and predictability: If one of my kids buys something on the basis that it was on sale and, therefore, a bargain and I disagree, the precedents are decidedly clear that I am always wrong. CL

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