THE LENDING AND SECURED FINANCE REVIEW

EIGHTH EDITION

Editor
Azadeh Nassiri

THE LAWREVIEWS

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PREFACE

This eighth edition of *The Lending and Secured Finance Review* contains contributions from leading practitioners in 16 different countries, and I would like to thank each of the contributors for taking the time to share their expertise on the developments in the corporate lending and secured finance markets in their respective jurisdictions, and on the challenges and opportunities facing market participants. I would also like to thank our publishers without whom this review would not have been possible.

I hope that the commentary that follows will serve as a useful source for practitioners and other readers.

Azadeh Nassiri
Slaughter and May
London
June 2022

Chapter 1

CANADA

Jean E Anderson, David Wiseman, David Nadler, Caroline Descours, Michael Royal, Kyle Gerow and Cathy Costa-Faria[1]

I OVERVIEW

i General

2021 witnessed a rebound in the corporate lending market as the Canadian economy continued to recover from the fallout of covid-19. The uncertainty that precipitated tightened lending conditions early on in the pandemic gave way to a more competitive landscape for lenders. In particular, pent-up liquidity and heightened demand for new loans generally led to more borrower-friendly conditions for new credit facilities as well as for amendments to existing credit facilities. Many borrowers took advantage of these conditions and negotiated accommodations addressing the impact of covid-19 on their businesses – including acknowledgements that any such impacts previously disclosed to lenders will not constitute a material adverse effect as well as certain add-backs to EBIDTA to account for covid-19-related losses.

At the outset of covid-19, the Canadian federal and provincial governments introduced a number of financing and other credit support programmes to support Canadian businesses negatively affected by the pandemic and to ensure continued liquidity in the credit markets. Demand for these support programmes declined in 2021 in the wake of improved business conditions and the increased availability of traditional financing. Many of these programmes have also expired or are set to expire in the near term. The gradual winding down of government support programmes related to covid-19 has led to some speculation that Canadian insolvency filings will rise in 2022 – particularly among businesses with poor credit that might otherwise encounter difficulty accessing traditional financing.

The trends of historically low (but rising) interest rates and high liquidity have continued into 2022, and, as a result, leveraged loans continue to be attractive to Canadian borrowers. Factors to monitor in 2022 include global inflation and its impact on interest rates, the increase in alternative lending sources (including private credit funds), the growth of sustainable finance, the impact of open banking and the ongoing recovery of the Canadian economy.

ii Standardised terms

In 2004, the Canadian Bankers Association published the Model Credit Agreement Provisions to be used in syndicated loan transactions in Canada. The goal of the Provisions was to standardise selected provisions of loan agreements to more easily facilitate secondary market

1 Jean E Anderson, David Wiseman, David Nadler, Caroline Descours and Michael Royal are partners, and Kyle Gerow and Cathy Costa-Faria are associates at Goodmans LLP.

trading, and include standard provisions relating to assignments and loan trading. They are based on provisions prepared by the Loan Syndication and Trading Association, Inc. Use of the Provisions is not mandatory, but they are commonly used in syndicated loan transactions where the administration agent is a major Canadian bank.

iii Recent Canadian deal activity

Deal volume in the Canadian M&A market in 2021 increased considerably from 2020, with a total of 3,857 deals announced. The aggregate value for announced deals reached C$359 billion – setting a new high-water mark for Canadian M&A activity in a single year.[2] Deal volume in 2021 peaked in the first quarter with 1,007 announced transactions, and continued at a robust pace for the following three quarters.[3] Mid-market transactions continued to be the driving force behind the high level of activity.[4] Sectors that saw significant activity in 2021 were information technology, real estate and mining.[5] The trend of Canadian firms continuing to be more active abroad than foreigners acquiring Canadian companies continued, with the majority of all foreign acquisitions made by Canadian firms being in the United States.[6]

iv Canadian financing sources

Canadian companies continue to finance their operations in a variety of ways. Day-to-day operations and cash management are generally financed with operating loans or lines of credit that are entered into with a company's primary financial institution. Asset-based loans, financed on the security of a company's working capital assets, also continue to be a frequently used source of financing for many Canadian companies, particularly in the manufacturing, distribution and retail sectors. In many cases, a significant portion of the consideration for acquisitions is funded through various types of debt obtained from a variety of sources, including senior secured credit facilities provided by domestic and foreign financial institutions, second lien credit facilities, unsecured credit facilities, streaming arrangements, high-yield notes and mezzanine debt. There has also been an increase in the number of privately financed deals in the Canadian market. Since the onset of covid-19, government funding and credit programmes have become a significant source of funding for businesses adversely affected by the pandemic (though many of these programmes are set to expire in the near term).

II LEGAL AND REGULATORY DEVELOPMENTS

i Lender-related regulatory requirements

Canadian borrowers regularly obtain financing and leveraged finance products from a broad range of lenders, including domestic and foreign financial institutions, private equity and hedge funds, and through the issuance of public debt, including high-yield debt. Canadian

2 Crosbie & Company, Canadian M&A Publications, online: www.crosbieco.com/who-we-are/m-a-publications. Figures provided were compiled from the 2021 quarterly reports.
3 ibid.
4 ibid.
5 ibid.
6 ibid.

and foreign banks are very active in this area and provide a wide variety of debt products to Canadian borrowers. The key regulatory issue for lenders dealing with Canadian borrowers is whether the lender would be considered a bank for Canadian regulatory purposes. The activities of Canadian banks and foreign lenders affiliated with foreign banks that are carrying on banking business in Canada are subject to regulation under the federal Bank Act. Lenders that are banks or affiliated with foreign banks must obtain the necessary approvals under the Bank Act to establish a presence in Canada, and must comply with certain operational requirements of the Bank Act on an ongoing basis.

Foreign lenders affiliated with foreign banks that do not have a presence in Canada may lend to Canadian borrowers without obtaining regulatory approvals from federal banking regulators, if the lending relationship is established in a way that would not involve the lender being viewed as carrying on business in Canada. Generally, a loan that is made by a lender located outside Canada, and that is approved, negotiated and documented outside Canada with payments being made to an entity outside Canada should satisfy this test.

Without connection to a bank, foreign and other lenders that are not otherwise regulated as financial institutions in Canada (e.g., insurance companies, trust companies, credit unions and private lenders) do not require any special licences or regulatory approvals to make a loan to a Canadian borrower. These lenders will, however, be subject to laws of general application that apply to the taking and enforcement of security in certain provinces. For example, a lender may require an extra-provincial licence under provincial legislation to hold and enforce a mortgage on real estate in that province. Lenders that lend on the security of real property may also need to obtain a mortgage brokerage licence under provincial legislation if it is not a financial institution exempted from compliance.

Although not a Canadian regulatory issue per se, foreign lenders entering the Canadian market will also need to consider their ability to fund loans in Canadian dollars, as many Canadian borrowers require Canadian dollar borrowings.

ii Borrower-related regulatory requirements

The activities of many Canadian borrowers are subject to some degree of government regulation, and often a particular government licence or approval is a key component of the borrower's business operations. Lenders to such borrowers should ensure that the borrower obtains all necessary governmental consent required to grant security on its assets to secure the proposed financing and to permit the lender to realise on its security. In addition, any transfer of a regulated borrower's assets (including any applicable licences) as part of the realisation process may require further governmental approvals, including approval of the proposed acquirer.

iii Anti-money laundering legislation

The Proceeds of Crime (Money Laundering) and Terrorist Financing Act makes it mandatory for certain entities (including lenders) to ascertain the identity of Canadian borrowers and related parties before accepting them as clients; to report a variety of transactions to the Financial Transactions and Reports Analysis Centre of Canada; and to maintain certain client and transaction records. These requirements are designed to assist in the detection and deterrence of money laundering and the financing of terrorist activity in Canada and around the world. Lenders should ensure that their due diligence requirements include a request for the information necessary to ensure compliance with this legislation.

iv Basel III

Canada's federal banking regulator, the Office of the Superintendent of Financial Institutions (OSFI), recently announced revised capital, leverage, liquidity and disclosure rules that incorporate the final Basel III banking reforms with adjustments specifically tailored for Canadian banks. Most of these rules will come into force in 2023, with certain rules concerning market risk and credit valuation adjustment risk taking effect later in 2024. Canada's banks remain among the best-capitalised in the world in terms of quality and quantity of capital.[7]

III TAX CONSIDERATIONS

i Withholding tax

Under the Income Tax Act (Canada) (the Tax Act), interest paid by a Canadian-resident debtor to an arm's-length non-resident creditor will not generally be subject to the Canadian withholding tax, provided that the interest is not participating (e.g., contingent or dependent on the use of or production from property in Canada; computed with reference to revenue, profit, cash flow, commodity price or similar criteria; or by reference to dividends paid). Where interest is subject to withholding tax under the provisions of the Tax Act (either because it is paid to a non-arm's-length creditor or is participating), the terms of an applicable bilateral tax treaty may apply to reduce the rate of withholding tax from the Canadian domestic rate of 25 per cent. Under the provisions of the Canada–US Income Tax Treaty, the rate is reduced to 15 per cent if the interest is participating, or otherwise to zero per cent. Most other treaties reduce the rate of withholding tax on interest to 10 per cent.

Under Canada's 'back-to-back' rules, additional withholding tax may apply where an intermediary is interposed between a foreign lender and a Canadian borrower, and a higher rate of Canadian withholding tax would otherwise apply in respect of payments to the foreign lender.

ii Interest deductibility

Interest is only deductible to a Canadian-resident debtor where it meets certain technical requirements set out in the Tax Act. In particular, interest (not in excess of a reasonable amount) is generally deductible on: (1) borrowed money used for the purpose of earning income from a business or property; or (2) an amount payable for property that is acquired for the purpose of gaining or producing income from a business or property.

Interest payable on financing incurred to fund the acquisition of an asset to be used in the debtor's business should generally be deductible. Similarly, interest payable on financing incurred to fund the acquisition of shares of a company (where there is a reasonable expectation of income from the shares) should also generally be deductible. Where the Canadian-resident debtor incurs debt to finance the acquisition of shares, and it then amalgamates with, or winds up, the target company, the interest payable on that debt will generally continue to be deductible (on the basis that the income-producing shares are now replaced with income-producing assets).

7 https://cba.ca/global-banking-regulations-and-banks-in-canada.

iii Thin capitalisation rules

Under the Tax Act, interest payable by a Canadian-resident debtor may not be deductible to the debtor, and also may be subject to Canadian withholding tax on an accrual basis, if the Canadian thin capitalisation rules apply. These rules generally apply where: a non-resident creditor owns or has a right to acquire (or is non-arm's-length with a person who owns or has the right to acquire) shares of the debtor representing 25 per cent or more of the votes or value of the debtor's capital stock; and the debt-to-equity ratio of the debtor exceeds 1.5:1.

The thin capitalisation rules may apply in a situation where financing is undertaken by a non-resident parent corporation that then on-lends the funds to its Canadian subsidiary.

Under Canada's 'back to back' rules, the thin capitalisation rules may apply where an intermediary is interposed between a non-resident creditor and a Canadian borrower, and the thin capitalisation rules would otherwise apply in respect of payments to the non-resident creditor.

iv 2021 Federal Budget proposals

In 2021, the Canadian Federal Budget proposed the introduction of new interest deductibility and anti-hybrid structure rules, which may affect the deductibility of interest by Canadian-resident borrowers.

In February 2022, draft legislation was released respecting (among other measures) the previously proposed interest deductibility rules, referred to as the 'excessive interest and financing expenses limitation' (EIFEL) rules. The EIFEL rules are broadly in line with OECD BEPS Action 4, and seek to introduce a limit on the amount of interest and financing expenses that resident and non-resident corporations and trusts can deduct in computing income. More specifically, the basic regime under the EIFEL rules generally limits the deduction of interest and financing expenses to 30 per cent of the taxpayer's 'adjusted taxable income' (i.e., tax EBITDA), with a transitional rate of 40 per cent for taxation years beginning on or after 1 January 2023 but before 1 January 2024. Interest and financing expenses that exceed the applicable limit in a particular year will not be deductible in that year, but generally may be carried forward for up to 20 years and deducted in those future years (subject to the application of the EIFEL rules in those years). Canadian corporations that do not exceed their applicable limit in a particular year generally will be permitted to transfer all or a portion of their 'excess capacity' to other Canadian corporations within their group. Further, taxpayers generally may carry forward for up to three years their 'excess capacity' to be utilised in those future years (subject to the application of the EIFEL rules in those years).

Members of certain groups of corporations and trusts may be permitted to effectively opt out of the basic regime in a particular year and elect into an alternative (and potentially more favourable) regime under the EIFEL rules for that year. Where applicable, this alternative regime may permit members of the group to deduct interest and financing expenses beyond the 30 (or 40) per cent limit where the overall group has a higher 'group ratio' of net third-party interest expense to earnings.

The EIFEL rules, once effective, will not apply to: groups of corporations and trusts whose aggregate net interest expense among their Canadian members does not exceed C$250,000; certain Canadian-resident corporations and trusts (and groups consisting of Canadian-residents corporations and trusts) that carry on substantially all of their business in Canada (provided that certain other requirements are met); and Canadian-controlled private corporations that have (together with any associated corporations) taxable capital employed in Canada of less than C$15 million. Individuals will also be exempt from the EIFEL rules.

Draft legislation respecting the anti-hybrid structure rules proposed in 2021 has not yet been released. These rules are expected to be in line with OECD BEPS Action 2 and, once implemented, generally will restrict the deduction of certain payments made by Canadian taxpayers under hybrid mismatch arrangements to the extent that the payments give rise to a further deduction in another country or are not included in the income of a non-resident recipient. Similarly, where a payment by a non-resident is deductible for foreign income tax purposes, no deduction in respect of this payment may be permitted to a Canadian taxpayer. Draft legislation respecting the anti-hybrid rules is expected to be released in two packages, with the first legislative package applicable as of 1 July 2022.

v Consolidation issues

Canadian-resident corporations do not file consolidated tax returns (unlike in certain other jurisdictions, such as the United States). As a result, interest payable by a Canadian-resident corporation is only deductible by that particular corporation and can only offset income earned by that particular corporation. Where the taxable income of the debtor corporation is insufficient to offset the interest deductions, other transactions may need to be undertaken to efficiently use the interest deductions in the corporate group. In particular, when an acquirer incurs debt to finance the acquisition of a target corporation, additional steps (such as the amalgamation of the acquirer with the target) may need to be undertaken to facilitate the deduction of the interest on the acquisition financing against the target's operating income.

vi Stamp and documentary taxes

There are no stamp or other documentary taxes in Canada to which loan or securitisation documentation or loan trading documentation might be subject.

vii Foreign Account Tax Compliance Act

Under the US Foreign Account Tax Compliance Act (FATCA), payments made to foreign creditors under Canadian financing or leveraged finance arrangements may, in certain circumstances, be subject to a 30 per cent US withholding tax. Where there is a risk of FATCA withholding, the applicable loan or debt financing instrument will typically require the foreign creditor to provide such documentation as may be necessary for the debtor to comply with its obligations under FATCA and to determine whether the creditor has complied with its obligations under FATCA, or to determine the amount of FATCA withholding tax that will be deductible from payments made under the instrument. A Canadian debtor will typically not provide a gross-up to the foreign creditor for amounts deducted because of FATCA withholding tax.

IV CREDIT SUPPORT AND SUBORDINATION

Secured loans are commonly used in the Canadian debt market to finance working capital, acquisitions and longer-term borrowing needs. The forms of security and quasi-security (such as guarantees) most commonly used in the Canadian market to secure personal and real property assets, as well as the regime for taking security under the Civil Code of Quebec (QCC) and the common law applicable in the other provinces and territories, are discussed below.[8]

i Security

Personal property – tangible property

Common law provinces

Each of the common law provinces and territories in Canada has a personal property security statute (collectively, the PPSAs) that is modelled on Article 9 of the Uniform Commercial Code in the United States. In secured financings in the Canadian market, tangible property typically means goods that are equipment or inventory.

Security in this type of property is created when a debtor grants to the creditor a security interest in that property. The granting clause in the security agreement will expressly describe the collateral that the security interest attaches to. Quite often, secured creditors are given a general security interest that secures all of the debtor's existing and after-acquired personal property, both tangible and intangible.

A security interest in goods must be perfected if a creditor is to have priority over the interests of other creditors and third parties. Registration of a financing statement in the province or territory where such assets are physically located is necessary to perfect a security interest in those assets. The PPSAs are publicly accessible, searchable databases and a registered financing statement serves as a public notice that a debtor's assets have been encumbered in favour of a secured creditor. The cost to file a financing statement under the various PPSAs is nominal and varies slightly with the length of the filing term. Secured parties must file under the PPSAs in every province or territory where such assets are located if they wish to be perfected against all of those assets.

Chattel paper,[9] instruments, money and negotiable documents of title in tangible form can also be perfected by a secured party by possession.

Quebec

Security over tangible movable property in Quebec is created by a hypothec. Registration at the Register of Personal and Movable Real Rights (RPMRR) perfects the hypothec. The cost to register at the RPMRR is nominal and varies slightly with the length of the filing term. No written agreement is needed where a hypothec is taken with delivery (i.e., a pledge). Perfection occurs when the pledged collateral is physically delivered to the pledgee.

8 The common law provinces and territories in Canada are: British Columbia, Alberta, Saskatchewan, Manitoba, Ontario, New Brunswick, Nova Scotia, Prince Edward Island, Newfoundland, Nunavut, the Yukon Territories and the Northwest Territories.

9 In Ontario, as of 15 May 2020, the PPSA was modernised to recognise both tangible, 'wet ink' chattel paper and electronic chattel paper. Similar amendments were made to the PPSA in Saskatchewan in 2019. In Ontario, under the new regime, electronic chattel paper can be perfected by control. Related changes have been made to the conflict of laws and the priority rules. Given the recognition of electronic chattel paper in the United States under the Uniform Commercial Code and the Ontario and Saskatchewan PPSAs, we expect that in time the PPSAs in the other Canadian provinces and territories will be updated with similar changes.

Federal jurisdiction

Security in aircraft, ships and most railways is governed in Canada by federal legislation. Though security interests in these types of assets can be taken under the PPSAs or the QCC, secured parties are well advised to consider any applicable federal legislation and to take any additional steps prescribed therein to establish a first-ranking claim on such assets.

Personal property – intangible property

Common law provinces

Intangible personal property commonly dealt with in the Canadian market includes claims and receivables, contractual rights and intellectual property (IP) rights.[10] Generally, creditors secure intangibles similarly to tangibles, by way of a security agreement and perfection by registration under the PPSAs.[11] The law of the jurisdiction where the debtor is located at the time the security interest attaches governs the validity, perfection and priority of a security interest in intangible personal property.[12] Accordingly, the secured party must file under the PPSA in the province or territory where the debtor is located to perfect against intangible personal property. Secured parties must also file in the jurisdiction the debtor is located to perfect non-possessory interests in certain collateral such as instruments, negotiable documents of title, money and chattel paper.

IP rights are governed by federal legislation, but these rights are personal property under the PPSAs and are considered intangibles. A security interest is created in IP rights through a grant of security under a security agreement, and is perfected by registration under the applicable PPSA. In addition, it is common practice for secured creditors with a security interest in Canadian trademarks, copyright or patents to file a copy or notice of the security agreement with the Canadian Intellectual Property Office.

Quebec

Under the QCC, the law of the jurisdiction where the grantor is domiciled (i.e., where its registered office is located) governs the validity and perfection of security over intangibles. Intangibles owned by a debtor domiciled in Quebec are secured under the QCC by way

10 The PPSAs expressly exclude an interest in or claim under any insurance policy or annuity contract from their scope. Secured debtors must take steps outside the PPSAs to secure an interest in an insurance policy. The PPSAs do, however, provide that a previous security interest in other secured personal property assets extends to the proceeds of insurance on those assets. In Quebec, insurance policies can be charged by a hypothec.

11 Certain government receivables payable by the federal government, and the provincial and territorial governments cannot be assigned or transferred as security unless secured parties comply with certain conditions prescribed by statute.

12 Generally, under the PPSAs, a debtor is located at its place of business or if a debtor has more than one place of business, where it has its chief executive office. In Ontario, however, deeming rules for determining a debtor's location under the Personal Property Security Act (Ontario) became effective on 31 December 2015. These rules determine a debtor's location based on what type of entity the debtor is. For example, provincial corporations are deemed to be located in the province or territory of incorporation or organisation. Similar rules have been adopted in British Columbia and Saskatchewan.

of a hypothec that is perfected by filing in the RPMRR. A hypothec on monetary claims (cash) is perfected by obtaining a control agreement with the financial institution holding the bank account.

Personal property – investment property

Financial assets such as shares and other securities are considered investment property under the PPSAs. Each of the common law provinces and territories has a Securities Transfer Act (STA) or similar legislation that is based on the revised Article 8 of the Uniform Commercial Code. The STAs work together with the PPSAs to govern the creation and perfection of security interests in investment property. The QCC also contains provisions specific to investment property.

Investment property under the PPSAs and the STAs includes securities (uncertificated and certificated), securities entitlements, securities accounts, futures contracts and futures accounts. In secured financings, the type of investment property seen most commonly is certificated shares. A borrower or guarantor would typically pledge the certificated shares it holds directly in a subsidiary to a lender to secure its obligations owing to that lender.

In addition to execution of a security agreement and filing under the PPSAs to perfect an interest in investment property, secured creditors can also establish 'control' or possession over the property. Control is the best method for perfecting such an interest as it gives the secured party a higher priority than a security interest perfected by registration alone.

Where investment property is held directly by a debtor, a secured party obtains control of certificated securities by taking possession of the certificates and either taking an endorsement or having the securities registered in its name. For uncertificated securities, control is achieved by either registering the securities in the name of the secured party or obtaining a control agreement from the issuer of the securities. A control agreement is a tripartite agreement among the issuer, the debtor and the secured party, and provides that the issuer agrees to comply with instructions from the secured party with respect to the securities without the debtor's further consent.

Where the investment property consists of securities entitlements held indirectly by the debtor through a securities intermediary, the secured party obtains control by:

a arranging for the securities intermediary[13] to record the secured party as the entitlement holder;

b obtaining a control agreement from the securities intermediary; or

c having a third party obtain control on its behalf.

Real property

The most common forms of security over real estate in the Canadian market are mortgages, debentures, hypothecs and trust deeds. Real estate in the common law provinces and territories includes land (together with buildings and fixtures), airspace above land, crops, forests, non-navigable waters, easements, subsurface land rights, rental income, and other profits derived from land and leasehold interests. Real estate under the QCC includes the following:

a land;

b any construction or work of a permanent nature located on the land, and anything forming an integral part of the land;

13 For example, a clearing house, retail investment broker or bank.

c plants and minerals that are not separated or extracted from the land;
d personal property that is permanently physically attached and joined to an immovable, and that ensures its utility and real rights in immovable property; and
e actions to assert such rights or to obtain possession of immovables.

Each province and territory has a real property title registration system. Secured creditors perfect interests in real property by filing a mortgage, debenture, hypothec or trust deed against the title to the debtor's real property. Generally, registration fees for real property mortgages are nominal. However, in several provinces and territories (Alberta, Newfoundland, Northwest Territories, Yukon Territories and Nunavut) registration costs can be higher as they are calculated based on varying formulas that take into account the principal amount of the mortgage that is being registered. Lastly, there are several special statutes that govern most federally regulated facilities such as airports, prisons and major shipping ports, and these should be assessed when taking security involving these types of facilities.

Security over all or substantially all of the debtor's assets

Security over all of a debtor's present and after-acquired property is commonly taken by secured parties. To do so, standard practice is generally to take separate security agreements – some for personal property (e.g., general security agreements, stock pledge agreements and sometimes intellectual property security agreements) and others for real property (e.g., a hypothec or debenture) – that together encumber all of the debtor's property. Though it is possible to secure both real and personal property in single documents such as a debenture, this practice is seen less often in the Canadian market and primarily on real-estate-based transactions.

ii Guarantees and other forms of credit support

Guarantees are a common feature of secured lending structures for financings in the Canadian market. Typically, a guarantor (e.g., a parent or corporate affiliate of the borrower) will enter into a stand-alone guarantee with a lender that guarantees the obligations of the borrower to the lender. In the acquisition context, it is not uncommon for the obligations of a sole-purpose acquisition entity to be guaranteed by an equity sponsor or controlling parent company. In Quebec, suretyships are used frequently in secured lending.

Financial assistance

Corporate legislation has eliminated outright restrictions on financial assistance. It is permitted without restrictions of any kind in several provinces, including Ontario, Nova Scotia and Quebec. In other provinces and territories, financial assistance is also permitted generally but is subject to a solvency test or disclosure requirements. This more relaxed regime has provided increased flexibility to lenders in Canada when structuring security packages that include guarantees.[14]

14 Certain provisions of the Corporations Act (Newfoundland and Labrador) restrict the ability of a corporation to provide financial assistance to related persons where the assistance would jeopardise the solvency of the corporation. In addition, Section 78 of the Corporations Act (Newfoundland and Labrador) prohibits a corporation from giving financial assistance, which may be a loan, guarantee or some

Corporate benefit

There is no corporate benefit requirement under Canadian corporate law statutes. However, a financing transaction that does not provide any apparent benefit to a corporation may be challenged as oppressive by creditors or minority shareholders, or may result in an allegation that the fiduciary duties of the corporate directors approving the transaction have been breached. Guarantees supporting the debt of affiliated entities are generally enforceable and valid in Canada as long as the debt is of benefit to the corporate group as a whole.

Agency concept

The concept of agency is recognised in all Canadian jurisdictions and is commonly used in secured loan structures. Agents are often used to represent lenders in a syndicate or to hold collateral on behalf of lenders.

Until relatively recently, the concept of holding security for others was not recognised under Quebec law. Most lending lawyers in Quebec had taken the view that an agent had to be formally appointed as a person holding the lenders' power of attorney to hold a hypothec without delivery on behalf of future, unknown members of a syndicate of lenders. In the spring of 2015, the Quebec government revised Article 2692 of the QCC to clarify this uncertainty. Under revised Article 2692, a hypothec may be granted to a 'hypothecary representative' for all present and future creditors of the obligations secured by that hypothec. This clarification has been well received in the Canadian market.

Challenging security under Canadian law

Under Canadian law, there are several ways that a creditor or court-appointed officer could challenge security either before or after the commencement of insolvency or restructuring proceedings. Remedies for 'reviewable transactions' are available under federal insolvency legislation and provincial legislation.

In the context of insolvency proceedings, a trustee in bankruptcy can challenge preferences and other transactions at undervalue under the federal Bankruptcy and Insolvency Act (BIA).[15] Under Section 95 of the BIA, a trustee in bankruptcy can challenge a preference – namely a transaction with a debtor or payment made by a debtor that has the effect of preferring one creditor over another, and that was entered into within prescribed periods before insolvency proceedings in respect of the debtor were commenced. If the preference is proven, the transaction or payment is void against the trustee in bankruptcy. Under Section 96 of the BIA, a trustee in bankruptcy can attack transactions between the debtor and persons who gave inadequate consideration for assets, goods or services provided by the debtor within prescribed periods before insolvency proceedings in respect of the debtor were commenced. Courts can order that transfers at undervalue are void against the trustee in bankruptcy, or that the parties to the transfer pay to the debtor's estate the difference between the consideration received by the debtor and the consideration given by the debtor. To the extent that transactions are rendered void as against a trustee in bankruptcy and the property

other structure, to certain blacklisted persons when 'circumstances prejudicial to the corporation exist'. The blacklist includes shareholders, directors, officers or employees of the corporation, and associates of these persons, subject to certain exceptions.

15 Where a trustee refuses or neglects to take proceedings after being requested to do so by a creditor, the creditor may make an application to the court for an order authorising it to take the proceedings in question in its own name, and at its own expense and risk.

in question has been further transferred, the BIA provides that the proceeds from the transfer of the property shall be deemed to be the property of the trustee. These sections of the BIA also apply (with any necessary modifications) to proceedings under Canada's other major insolvency and restructuring statute, the Companies' Creditors Arrangement Act (CCAA).[16]

Provincial legislation is also available to creditors or trustees to attack preferential transactions. Although there are differences among the various provincial statutes, most provinces allow a creditor to attack fraudulent conveyances and unjust preferences.[17] In general terms, fraudulent conveyances are transactions where conveyances of real or personal property are made with the intent to defeat, hinder, delay or defraud creditors or others. Unjust preferences are preferential payments or transactions made when the debtor was in insolvent circumstances, unable to pay its debts or knew it was on the eve of insolvency. Transactions found to be fraudulent conveyances or unjust preferences can be voided as against creditors.

Finally, in almost all Canadian provinces and territories, creditors may use the oppression remedy under corporate law to challenge security given by a corporation. This would involve a transaction where the corporation or its directors effected a result or acted in a manner that was oppressive, or unfairly prejudicial to or unfairly disregarded the interests of certain parties (including creditors). Where oppressive conduct is found, Canadian courts have broad discretion to grant any remedy they deem appropriate in the circumstances.

iii Priorities and subordination

Priorities

The priority of a claim of a creditor of an insolvent corporation will depend upon the nature of the claim and the insolvency proceedings applicable to the borrower. The enforcement of security may occur in the context of a proceeding under the CCAA or the BIA. An insolvent corporate borrower may reorganise itself under the CCAA or BIA or petition itself into bankruptcy under the BIA.

In a Canadian insolvency proceeding, certain claims may be afforded priority over a secured lender pursuant to a court order and the priority of these claims will be determined by the court based on the facts of each case. The court may, for example, grant a charge in priority to the security of existing lenders in the debtor's assets to secure, among other things, claims of, or in respect of, critical suppliers, debtor-in-possession lenders, directors' corporate indemnities, key employee retention payments and professional administration fees.

In addition, certain statutory claims will continue to have priority over a secured lender's claim in an insolvency proceeding. In a bankruptcy scenario, these include claims for unremitted employee source deductions, certain employee claims that are paid by the Canadian federal government under the Wage Earner Protection Act, and certain employee and employer pension plan contributions that are due and unpaid. In a CCAA restructuring or a BIA proposal, generally, the restructuring plan or proposal for the insolvent borrower must provide for the payment of certain employee and other claims unless otherwise agreed by the relevant parties.

16 In which case, the court-appointed monitor could challenge preferences and other transactions at undervalue. See Section 36.1(1) of the CCAA.

17 Court-appointed officers and other parties seeking to challenge a transaction or grant of security may rely on these provincial statutes both within insolvency proceedings under the BIA or CCAA and outside such proceedings.

Notably, a number of the Canadian federal and provincial statutory-deemed trusts that can prime a lender's security outside a bankruptcy for unpaid amounts, such as vacation pay and sales taxes, will be reversed in a bankruptcy of the insolvent borrower.[18] However, where a statutory trust satisfies the general principles of trust law for creating a true trust, the assets impressed with the trust would be excluded from any distribution to the insolvent borrower's secured creditors in the bankruptcy proceedings.[19]

As noted above, certain pension claims may rank in priority to a lender's security in the event of a borrower's insolvency. The Supreme Court of Canada decision in *Indalex Limited (Re)*,[20] however, created some doubt as to the priority afforded to the amount of any funding deficiency arising in connection with the wind-up (a wind-up deficiency) of a borrower's defined benefit pension plan. Before this decision, it was generally thought that the deemed trust provisions of the applicable pension legislation would not apply to a wind-up deficiency. Although the Supreme Court made it clear that a deemed trust could apply to a wind-up deficiency and that the claim for that amount would be subordinate to a court-ordered charge securing debtor-in-possession financing for the insolvent borrower, the court did not opine on the relative priority of liens on the accounts receivable and inventory securing indebtedness existing at the time a CCAA order is made.[21] Lenders providing financing to a Canadian borrower that has a defined benefit plan registered in Canada or to acquire a target with such a plan should determine whether a deemed trust could apply to a wind-up deficiency under the applicable pension legislation, and consider the impact on their security position in the event of an insolvency.

Lenders should also be aware of a notable decision of the Supreme Court of Canada, *Orphan Well Association et al. v. Grant Thornton Limited et al. (Redwater)*,[22] which considered Alberta's provincial regulatory regime regarding abandonment and reclamation obligations

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18 In *Callidus Capital Corp v. Canada*, 2018 SCC 47, the Supreme Court of Canada denied a taxing authority's efforts in the bankruptcy proceedings of the debtor to have its deemed trust for unremitted taxes upheld as against a secured creditor who, before the insolvent debtor's bankruptcy, received proceeds from the insolvent debtor that were deemed to be held in trust for the taxing authority.

19 In T*he Guarantee Company of North America v. Royal Bank of Canada*, 2019 ONCA 9, the Ontario Court of Appeal held that Ontario's Construction Lien Act impresses a true trust on the funds owing to or received by a bankrupt contractor, preserving those assets from distribution to the bankrupt contractor's creditors. In *Urbancorp Cumberland 2 GP Inc (Re)*, 2020 ONCA 197, in the context of a CCAA proceeding, the Ontario Court of Appeal found that Ontario's Construction Lien Act (now the Construction Act) creates a valid trust pursuant to general trust law, and this statutory provincial trust can be effective in an insolvency to the extent it does not conflict with a specific priority under federal law.

20 2013 SCC 6 (*Indalex*).

21 See also *Grant Forest Products Inc v. The Toronto-Dominion Bank*, 2015 ONCA 570 (Grant Forest). In Grant Forest, the Ontario Court of Appeal confirmed that a judge presiding over CCAA proceedings has the discretion to permit a creditor to petition the debtor company into bankruptcy, even when the transition to bankruptcy results in a loss of the pension deemed trust and an altering of priorities in favour of a secured creditor. In addition, the Ontario Court of Appeal – although not explicitly upholding the ruling of the lower court that a wind-up deemed trust does not prevail when a wind-up is ordered after the commencement of CCAA proceedings – did distinguish the facts from the *Indalex* case (the wind-up deemed trust under consideration in *Indalex* arose before the CCAA proceedings commenced, whereas in Grant Forest, neither of the pension plans were wound up until after the CCAA proceedings commenced).

22 2019 SCC 5.

(or end-of-life obligations) with respect to abandoned oil wells.[23] The Alberta Energy Regulator issued orders under the provincial regulatory regime requiring Redwater Energy Corporation, an insolvent oil and gas company, to fulfil its end-of-life obligations.

The majority of the Supreme Court held that, for a number of reasons, the Regulator's use of its provincial statutory powers to enforce compliance with end-of-life obligations under Alberta's provincial legislation does not create a conflict with the BIA and therefore does not trigger the doctrine of federal paramountcy.[24] This meant that the Alberta regime, which was binding on receivers and trustees, could be enforced against Redwater's trustee in bankruptcy such that Redwater's end-of-life obligations for its inactive oil and gas wells were to be satisfied from the insolvent estate, notwithstanding the impact on secured lender recovery.[25]

The treatment of environmental obligations in insolvency is an evolving issue, and the applicable provincial regulatory regime will factor significantly into a court's determination.[26]

Lenders will want to ensure they understand the applicable provincial regulatory regime, and its application in a potential insolvency, as well as ensure that lending values account for such risks where a Canadian borrower has potential environmental liabilities.

Equitable subordination

Under the US Bankruptcy Code, the doctrine of equitable subordination allows courts to subordinate creditor claims to those of lower-ranking creditors. This extraordinary remedy is typically reserved for situations of egregious conduct on the part of creditors, because it supplants negotiated contractual arrangements between parties. For a claimant to succeed in subordinating a creditor claim, it must demonstrate that the creditor engaged in inequitable conduct, that the conduct harmed other creditors of the bankrupt company or that an unfair advantage was conferred on the creditor, and that the subordination is consistent with the remainder of the US Bankruptcy Code.

Although there is no equivalent legislative provision in Canada, Canadian courts have suggested that the doctrine of equitable subordination could potentially be adopted in certain circumstances. In *Indalex*, the Supreme Court of Canada affirmed the 'wait and see' approach it espoused in *Canada Deposit Insurance Corp v. Canadian Commercial Bank*,[27] whereby rather than ruling one way on the doctrine's applicability, it declared that the facts at hand did not give rise to a claim for equitable subordination and left its determination for a later date.[28] In its subsequent decision in *US Steel Canada Inc (Re) (US Steel)*,[29] the Ontario Court of

23 These obligations refer generally to responsibilities for plugging and capping oil wells to prevent leaks, dismantling surface structures and restoring the surface to its previous condition.

24 The doctrine of federal paramountcy establishes that where there is a conflict between valid provincial and federal laws, the federal law will prevail and the provincial law will be inoperative to the extent it conflicts with the federal law.

25 *See also Manitok Energy Inc (Re)*, 2022 ABCA 117.

26 See, for example, *British Columbia (Attorney General) v. Quinsam Coal Corporation*, 2020 BCSC 640, where the British Columbia Supreme Court distinguished *Redwater* on the basis that the Alberta regime regulating the abandonment, closure and reclamation of oil and gas wells is different from British Columbia's Mines Act and allowed certain sale proceeds to be paid to the secured creditor while there remained unfulfilled regulatory obligations, including reclamation obligations imposed under the Mines Act.

27 20 [1992] 3 SCR 558, paragraph 44.

28 *Indalex*, footnote 17, at paragraph 77.

29 2016 ONCA 662.

Appeal ruled that the CCAA court does not have the jurisdiction under the CCAA to grant the remedy of equitable subordination. The Ontario Court of Appeal, however, left the door open for equitable subordination to apply in a BIA context on the basis that the BIA provides the court with express jurisdiction in equity. Leave to appeal to the Supreme Court of Canada was granted in respect of the Ontario Court of Appeal's decision in *US Steel*; however, the appeal was discontinued and the Ontario Court of Appeal decision remains the authority in Canada.

Second lien financings

As noted above, a Canadian borrower may incorporate several different types of indebtedness (including second lien loans) in its capital structure. Second lien loans (term B loans) are an increasingly popular source of financing in Canada for acquisitions, recapitalisations and restructurings. Non-bank entities such as hedge funds, private equity funds and distressed debt funds, particularly those based in the United States, are typically the providers of second lien loans to Canadian borrowers. As second lien loans are secured by a lien on all or a portion of the borrower's assets, these loans are generally considered to be a lower risk alternative to mezzanine loans and, accordingly, are less costly than mezzanine or other junior unsecured debt. In addition, as a result of investor demand for the enhanced yields available through leveraged products, second lien loan terms have become more debtor-friendly and a number of borrowers have been able to obtain covenant-lite loans. Often, these loans are provided in US dollars so are particularly attractive to Canadian borrowers with significant US-dollar cash flows that provide a natural hedge to currency exchange fluctuations that could otherwise affect their ability to make loan payments in US dollars.

The respective rights of the first lien lenders and the second lien lenders will be set forth in an intercreditor agreement. A first lien-second lien intercreditor agreement will certainly include a contractual subordination of the second lien lender's claim to the rights of the first lien lender and restrictions on the ability of the second lien lender to enforce its lien against the common collateral for the loans. The intercreditor agreement may also include provisions addressing the issues set out below.

Intercreditor agreements

Lenders have made a broad variety of debt products available to borrowers to finance their operations, acquisitions and other activities. As a result, many borrowers have complex capital structures with several layers of debt secured by liens on the same collateral. For example, a borrower may have a senior term and operating credit facility, hedging obligations, cash management obligations and a second lien term loan secured by liens on the borrower's assets. Lenders in these circumstances will typically enter into an intercreditor agreement that delineates their respective rights, remedies and priorities particularly in a default situation. Canadian courts will generally treat an intercreditor agreement as an enforceable contract between the lenders and uphold its provisions. However, if the borrower in question is subject to an insolvency proceeding, it is possible that the court supervising the proceeding may make an order that is inconsistent with the provisions of the applicable intercreditor agreement in exercising its jurisdiction over the matter.

The terms of any particular intercreditor agreement will be influenced by the borrower's creditworthiness and capital structure, the types and terms of the relevant debt, the lender's preferred exit strategies and the general economic environment. The primary purpose of an intercreditor agreement from a senior lender's perspective is to ensure that it is in a position to control the enforcement proceedings with respect to a defaulting borrower until the senior lender is repaid in full or is no longer prepared to continue. Intercreditor agreements also typically include provisions that deal with:

a the relative priority of liens on the collateral;
b the application and turnover of proceeds derived from the collateral, payment restrictions or blockage periods with respect to junior debt payments;
c restrictions on the type and amount of senior debt that ranks prior to more junior debt;
d standstill periods and other restrictions on enforcement proceedings by holders of junior debt;
e access rights to certain collateral;
f restrictions on certain modifications to the terms of each lender's credit documentation;
g refinancing rights; and
h the right of junior debtholders to purchase the senior debt.

Triggers for junior debt payment blockages, the frequency and length of payment blockage periods as well as the right to make catch-up payments once a payment blockage has ceased are often heavily negotiated. The elements and amount of senior debt (including interest rate and fee increases, over-advances, prepayment premiums and hedging obligations) that ranks in priority to the junior secured debt are also frequently the subject of much discussion.

V LEGAL RESERVATIONS AND OPINIONS PRACTICE

In syndicated lending transactions, legal opinions are generally delivered by counsel to the borrower and, where necessary, local counsel in each relevant province or territory. Such opinions typically include corporate opinions; non-contravention and no breach opinions; regulatory approval opinions; share capital opinions; enforceability opinions; and creation and registration of security opinions.

It is not uncommon for lending transactions in Canada to be financed by foreign lenders based in financial centres such as New York or London. This occurs most often when the borrower is foreign or part of a larger cross-border or international corporate structure, or where the transaction being financed is a cross-border transaction. Foreign lenders often expressly choose to have their principal financing agreement governed by the law of their home jurisdiction, and to stipulate that any resulting disputes will be governed by that law. In these circumstances, foreign lenders need to understand how choice of law and foreign judgments are treated in Canada and whether consent to jurisdiction clauses are enforceable.

i Choice of law

Generally, in a proceeding in Canada to enforce a foreign law-governed document, Canadian courts will, with limited exceptions, apply the law expressly chosen by the parties, so long as the choice of the foreign law in the agreement is bona fide, legal and not contrary to public policy. Canadian courts will apply local law to procedural matters and to the extent these laws have an overriding effect. In addition, they will not apply foreign law if to do so would have the effect of enforcing a foreign revenue, expropriation or penal law.

In the unlikely event that the parties do not expressly choose a system of law to govern the primary financing agreement, Canadian courts will apply the law that has the closest, and most real and substantial connection to the agreement.

ii Enforcement of foreign judgments

Without reconsidering the merits, and subject to certain defences, Canadian courts generally will issue judgments in Canadian dollars based on final and conclusive foreign judgments rendered against the person for a specified amount, if the action in Canada is brought within any applicable limitation period. Under certain circumstances, Canadian courts have the discretion to stay or decline to hear an action based on a foreign judgment. Such actions may also be impacted in Canadian courts by bankruptcy, insolvency or other similar laws affecting creditors' rights.

Certain defences are available to debtors in Canada to prevent recognition and enforcement of a foreign judgment against them. The foreign judgment cannot have been obtained by fraud or in a manner contrary to natural justice. In addition, the foreign judgment cannot be for a claim that under Canadian law would be characterised as being based on a revenue, expropriation or penal law, nor can the foreign judgment be contrary to public policy. Finally, courts will not enforce the foreign judgment if it has already been satisfied, or is void or voidable under the foreign law.

iii Submission to jurisdiction clauses

Agreements to submit all disputes related to the financing transaction to a specified jurisdiction are common in commercial financing agreements, and can be exclusive or non-exclusive. Under Canadian law, non-exclusive jurisdiction clauses have historically been held to be enforceable. Recent Canadian case law, including decisions from the Supreme Court of Canada, has strongly supported enforcement of exclusive jurisdiction clauses to increase predictability and certainty in the Canadian market.[30]

VI LOAN TRADING

The market for syndicated loans continues to be the primary means for borrowers to access financing. Syndication continues to be the avenue used by lenders to allocate and distribute exposure to certain borrowers or industry sectors. However, unlike the US loan market, the use of secondary trading in loans is limited and there is no significant market for loan participations. Syndication or assignments of loans and lending commitment are the most common methods of transferring loan exposure in Canada. Assignment by a lender of its loan position is usually permitted, subject in some cases to the borrower's consent or only to a permitted list of assignees, and to the general requirement that the assignment must not result in increased costs to the borrower. Because the lack of a significant secondary market for trading loans limits term B loan availability in Canada, many large Canadian companies have instead chosen to access the term B loan market or the second lien loan market available in the United States.

Loan participants in Canada, as in most other markets, do not have a direct contractual relationship with the borrower. Though a participant assumes the risks associated with the loan transaction in which it is participating, it has no direct interest or rights under any credit documents, including the security, if any, related to the loan. In addition to the credit risk associated with a borrower, a participant also faces the risk related to the solvency of the grantor of a participation in a loan. If the grantor of a participation files for bankruptcy,

30 *ZI Pompey Industries v. Ecu-Line NV* [2003] 1 SCR 450.

for example, a participant's right to receive payment on its underlying loan will continue to depend upon and flow through the grantor and not the borrower. The terms of the particular participation agreement will determine the rights available to the participant in a grantor's bankruptcy as a secured or unsecured creditor.

VII OTHER ISSUES

There are currently no other issues of note.

VIII OUTLOOK AND CONCLUSIONS

Despite geopolitical headwinds and inflationary pressures, it is expected that Canadian borrowers will continue to actively seek funding in the Canadian and US debt markets for acquisitions, dividend recapitalisations and other balance sheet restructurings and corporate purposes given historically low interest rates and opportunities arising from Canada's ongoing economic recovery. In addition, Canada will continue to respond to global regulatory changes and market trends – especially those occurring in the US. These trends include the ongoing adoption of alternative reference rates (such as SOFR), the growth of fintech lending, the emergence of sustainability-linked loans and the gradual winding down of government financing and other support programmes related to the covid-19 pandemic.

As US sponsors become more active in Canada and seek financing from Canadian lenders for their Canadian acquisitions, covenant-lite loans are becoming more common in Canada. Covenant-lite loans generally do not include financial maintenance covenants, or include them only on a springing basis based on certain leverage levels. Equity cures of financial covenant breaches are generally permitted. As financial covenant breach is often an early indicator of financial difficulty, the downside for lenders is that they may not be able to trigger a default based on a financial covenant breach and thus initiate restructuring discussions at an early stage when more options are available to address the borrower's financial issues.

Incremental or 'accordion' facilities that permit the borrower to increase the amount of term or revolver facilities available, or to incur additional indebtedness in another form are an increasingly common feature of leveraged loan facilities in Canada, and are often used to finance acquisitions. The terms for these incremental facilities are generally becoming more borrower-friendly. The borrower is usually permitted to incur a fixed amount of additional debt subject to further increases, if certain financial ratios are satisfied. Most favoured nation restrictions with respect to interest rate spreads for additional debt and other protections for existing lenders with respect to the terms of incremental debt are also continuing to weaken.

Unitranche lending has also gained some popularity with Canadian borrowers, particularly those exposed to US lenders through their US affiliates. Unitranche facilities combine senior and junior debt into one credit facility, with the lenders addressing their respective priorities with a first-in, last-out mechanism under an agreement among lenders.

Another trend is the increased activity level of foreign lenders in Canada, particularly those based in the United States. The increasing level and size of cross-border transactions has created new lending opportunities for foreign lenders in Canada. Many foreign lenders are also seeking to expand their relationship with clients in their home jurisdictions to affiliates of those clients located in Canada. A number of foreign lenders have established a local presence in Canada such as a foreign bank branch, and are offering a wide variety of financial products to Canadian clients. Further, there has been an increase in the number of private or alternative lenders in the Canadian market, providing bespoke financing arrangements to address borrowers' unique financing needs and credit challenges. The increased competition in the Canadian financial market resulting from entry of additional foreign lenders and private lenders should be beneficial to Canadian borrowers.

Appendix 1

ABOUT THE AUTHORS

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Jean E Anderson is a partner in the banking and finance law group at Goodmans. Her practice focuses on financing, corporate transactions and regulatory matters. With more than 30 years of extensive expertise in the areas of complex domestic and cross-border financings, project finance, structured finance, asset-based lending, debt restructuring and regulatory matters relating to financial institutions, she is recognised as a leading practitioner of banking and finance law by *Chambers Global*, Euromoney's *Guide to Banking Lawyers* and *Guide to Women in Business Law*, *IFLR1000*, *Best Lawyers in Canada*, *The Legal 500 Canada* and Law Business Research's *Who's Who Legal: Banking*. She is recognised for asset-based lending and banking by *The Canadian Legal Lexpert Directory*, *The Lexpert/American Lawyer Guide to the Leading 500 Lawyers in Canada* and *The Lexpert Guide to Leading US/Canada Cross-Border Corporate Lawyers in Canada*. In addition, Jean was named the '2015 Toronto Asset-Based Lending Lawyer of the Year' by *Best Lawyers in Canada* and she also received the 2009 Lexpert Zenith Award recognising her as one of Canada's leading women lawyers. She formerly served as a law clerk to the Chief Justice of the Ontario Court of Appeal, and was admitted to the Ontario Bar in 1981.

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