CROSS BORDER LENDING ISSUES

Michael Bertrand

November 30, 2010

Goodmans LLP

I. OVERVIEW OF DIFFERENCES BETWEEN U.S. AND CANADIAN RESTRUCTURING LAW

- Focus of presentation is on large corporate bankruptcies/reorganizations
- Canadian reorganization statute: *Companies' Creditors Arrangement Act* or the "CCAA"
  - Minimalistic approach
  - Less codified: relies heavily on judicial discretion and interpretation
  - 2009 Amendments do codify a few additional matters to bring it more in line with the U.S. (DIP financings; disclaiming leases and agreements; asset sales; preferential transactions)
  - Debtor-in-possession restructuring statue carried out under a court process; different from formal bankruptcy in Canada

- United States *Bankruptcy Code* or the "Code"
  - Complex "rules-based" code with extensive provisions that govern the conduct of reorganization proceedings
  - Many procedural requirements
  - More certainty than the Canadian legislation, although less flexibility
  - Debtor-in-possession corporate reorganizations are carried out under a formal bankruptcy process

- ***DIFFERENCES – GENERAL OBSERVATIONS***
- Canada
  - As a general rule, it's faster (and therefore less expensive as compared to the US)
  - Less litigious (i.e., no unsecured creditors' committee; impartial court-appointed monitor assists in resolution of disputes)
- US
  - May be slower (due to more procedures being codified, prescribed timelines, etc.)
  - More potential for litigation due to unsecured creditors' committee and certain equitable doctrines not present in Canada

- ***STAY OF PROCEEDINGS***
- Canada
    - Stay of proceedings that protects the debtor from creditor action is not automatic
    - Instead, the CCAA gives the court the power to stay proceedings against the debtor (ie, stay can be included in the initial CCAA order of a court – as a result, there is usually a degree of secrecy/privacy around obtaining the initial order)
    - Breadth of stay is in the discretion of the court (note that initial stay is for 30 days only)
- United States
    - Stay of proceedings is automatic under the Code by operation of law upon filing of a petition
    - Continues in effect until end of a case

- Stay generally stays all actions to enforce pre-bankruptcy claims (i.e., wide breadth)

- ***MONITOR VS. TRUSTEE***
- Canada:
  - If a stay is granted under the CCAA, the court must appoint a monitor (usually an accounting firm) to watch over the business and financial affairs of the debtor
  - The monitor does not have possession or control over the debtor’s business
  - However, the monitor generally tends to have a large role in reporting to the court and to creditors, and will often run the claims process and conduct the voting process.
  - The monitor may also take a more active role on behalf of creditors (i.e., where the debtor is disorganized or untrustworthy). The Monitor has recently been more active in protecting Canadian creditors in cross-border insolvencies since there is no unsecured creditors’ committee

- Under the new 2009 CCAA amendments, it is also the Monitor who must attack preferential pre-filing transactions

- United States
  - There is no single party with a role as broad as a monitor in US proceedings.
  - The United States Trustee (a government official) has a more limited role (in part because there is an official creditor's committee in the US that acts for creditors) and will oversee certain administrative aspects of bankruptcy proceedings.

- ***CREDITOR COMMITTEES***
- Canada
  - There is no requirement in Canada to form a creditors' committee, and only a very small number have been established by courts in large cases (the norm is for no creditors' committee at all)
- United States
  - An official unsecured creditors' committee ("UCC") is appointed in each case by the United States Trustee
  - The UCC acts as an independent fiduciary for, and represents the interests of, general unsecured creditors in a case
  - The UCC will have independent legal counsel, and all of its costs are funded by the bankruptcy estate
- The UCC is a key difference between US and Canadian bankruptcy/reorganization proceedings – the UCC is a real party with standing to be heard on any issue, etc.

- ***FILING A REORGANIZATION PLAN – EXCLUSIVITY***
- Canada:
  - There is <u>no</u> statutory period whereby the debtor is automatically the only party entitled to propose a reorganization plan
  - However, the initial CCAA order typically provides that the debtor alone (and no other party) is authorized to propose a plan: if given, this "exclusivity" typically lasts for the duration of the stay of proceedings
  - Exclusivity is not often contested in Canada, although technically could be
  - Note: there are a few recent cases where creditors have put forward a competing plan with court approval, so this is changing
- United States
  - The Code provides the debtor with a statutory exclusivity period of 120 days to develop a plan and 180 days to solicit votes (although

a court may extend or reduce these time periods, subject to maximum amounts)

- Once the exclusivity period has ended, other parties (i.e., the official creditor's committee, which has its expenses covered by the debtor's estate) can propose a competing plan

- ***PLAN APPROVAL – "CRAM DOWN" RIGHTS, ETC.***
- Canada
  - A CCAA plan must be approved by each class of creditor being affected by the plan.
  - A class approves a plan if more than 50% in number and 2/3 in value of the voting claims in that class vote in favour of the plan
  - A plan must be approved by <u>every</u> class of creditor in order to be binding on every class
  - A court can still approve a plan that has not been accepted by all classes, but the approved plan will only be binding on those classes that accepted it
- United States
  - The Code contains "cram down" rights that allow a debtor to force a plan on one or more classes of creditors whose claims are to be impaired (i.e., compromised)

- At least one impaired class must still accept the plan in order for the plan to be effective, and there are other requirements in the code in order for a cram-down to apply (i.e., a “crammed down” creditor must be paid an amount under the plan equal to at least the amount they would receive in a liquidation scenario, etc.)

CLAIMS OF UNPAID SUPPLIERS

- Canada
  - The CCAA does not afford any remedies to sellers of goods to the debtor immediately *before* the commencement of CCAA proceedings (i.e., such remedies are subject to any stay imposed in the CCAA proceedings)
  - There is no statutory priority or security in respect of claims for goods supplied during the CCAA proceedings; however, nothing in the CCAA prohibits suppliers from cancelling credit terms and requiring immediate cash payment for goods supplied after the CCAA filing
- US
  - Unpaid vendors of goods supplied within 20 days before the commencement of a Chapter 11 case are entitled to be paid in full as an administrative expense out of the bankrupt’s estate

- The vendor may also have a right to have its goods returned within certain time-frames

- ***PREFERENCE ACTIONS / TRANSACTION AVOIDANCE***
- Canada
  - Recent amendments to Canadian insolvency legislation provide the Monitor with the ability to review and challenge preferential pre-filing transactions under the CCAA
  - Historically, challenges to pre-filing transactions were less common in Canada than in the United States; it has yet to be seen whether the recent amendments will precipitate more frequent challenges to pre-filing transactions
- United States
  - Debtors have been given the right under the Code to sue creditors to avoid or recover payments made on the eve of insolvency
  - As a result, debtors in the US regularly file preference actions against any and all creditors who received any form of payment (subject to certain thresholds) within the 90 days leading up to the bankruptcy filing

- ***EQUITABLE SUBORDINATION***
- Canada
  - The CCAA contains no provision for “equitable subordination”
- United States
  - The principal is codified, and allows a court to subordinate a creditor’s claim or interest to another claim or interest where the claimholder is engaged in inequitable conduct and the conduct caused injury to another or an unfair advantage
  - For instance, equitable subordination frequently applies in situations where an insider has breached its duties to the corporation by managing the company for its own benefit at the expense of other stakeholders. If the insider has debt claims against the company, other creditors could apply to have the insider’s claims equitably subordinated to the claims of all other creditors on the basis of the insider’s inequitable conduct

II. CANADIAN WITHHOLDING TAX

- ***PRIOR TO JANUARY 1, 2008***
- Canada imposed a 25% withholding tax on interest paid to both arm's length and non-arm's length non-residents, subject to certain exceptions.
- Exceptions included:
  - interest on certain federal, provincial and municipal bonds;
  - interest payable to a non-resident owned investment corporation; and
  - five year corporate debt: the "5/25" rule:
    - no more than 25% of the debt could be repayable within the first 5 years of the debt, except under certain stated circumstances.
- Typically, cross-border lending was structured to fit within the 5/25 rule.

- The 5/25 rule was complicated and limited the breadth of commercial terms within the debt.

- ***AFTER JANUARY 1, 2008***
- In 2007, and in conjunction with the announcement of the Fifth Protocol to the Canada – U.S. Tax Convention, Canada announced that it would eliminate domestic withholding tax on interest subject to two exceptions.
- As of January 1, 2008, Canada will impose a 25% withholding tax on <u>interest</u> only where:
  - the interest is payable to a person with whom the payer is <u>not dealing at arm's length</u>, or
  - the interest is "<u>participating debt interest</u>".
- <u>A Non-arm's length</u> relationship will include:
  - parent-subsidiary;
  - sister subsidiary corporations;
  - factual non-arm's relationships.

- “Participating debt interest” is generally defined in the Tax Act as interest that is paid or payable on an obligation, all or any portion of which interest is contingent or dependent on the use of or production from property in Canada or is computed by reference to revenue, profit, cash flow, commodity price or any other similar criterion or by reference to dividends paid or payable to shareholders of any class.

- Very broad definition that must be considered when negotiating credit terms.

- For example, interest rates that rise with an increase in EBITDA will be participating debt interest and therefore subject to Canadian withholding tax.

- However, interest rates that decrease as EBITDA increases should not be considered to be participating debt interest even though such interest is computed with reference to revenue or similar criterion.

- CRA has stated that interest that decreases inversely to EBITDA is a proxy for credit worthiness and not an attempt to convert interest into a participating payment. Accordingly, such interest will not be considered to be participating debt interest.

- ***APPLICATION OF CANADA-US TREATY***
- Many of Canada's bilateral income tax treaties reduce the 25% domestic withholding rate to 10 – 15%.
- Canada – U.S. treaty currently reduces withholding to 0% (including for non-arm's length loans) for those entitled to the benefit of the treaty, unless the interest is participating interest in which case withholding would be 15%.
    - "Participating Interest" is similar to the concept of participating debt interest in Tax Act.
- Accordingly, interest paid to a non-arm's length U.S. resident (that is eligible to receive the benefit of the treaty) can be made free of Canadian withholding tax, unless the interest is participating.

- ***WITHHOLDING TAX ON DIVIDENDS TO NON RESIDENTS – DEEMED DIVIDEND PROBLEM***
- Dividends paid by Canadian resident corporations to non-residents are generally subject to withholding tax, unless there is treaty relief
- In some cases an intercompany loan made by a Canadian resident to a non-resident may be treated as a dividend for these purposes
- For example, a Canadian resident corporation intends to borrow money from a third-party creditor and to lend an amount to its parent, a U.S. resident corporation, on an interest-bearing basis.
- This scenario may arise where there is excess availability under a cross-border credit facility due to Canadian assets (and that excess availability is needed in the US).
- If the loan is left outstanding by the end of the year following the taxation year of the lender in which the loan was made, then under Canadian tax rules the whole amount of the loan will be deemed to be a dividend paid by the lender to the borrower.

- The deemed dividend characterization and accompanying withholding tax cannot be avoided by repaying the loan before the determinative time if a new loan is made at that time; the deemed dividend characterization will continue if the loan that is repaid was part of a series of loans and repayments.
- As a result, a 25% domestic withholding tax will be applied on the deemed dividend.
- The rate would generally be reduced under the U.S. – Canada tax treaty to 5% if the U.S. parent owns at least 10% of the voting stock of the Canadian subsidiary and if the Parent is entitled to the benefits of the treaty.

- ***DEEMED DIVIDEND: POSSIBLE WORK-AROUND***
- One possible transaction to avoid withholding tax is to have the Canadian subsidiary borrow funds under the credit facility with excess availability and then repay an amount on account of its paid-up share capital to the U.S. parent.
- If the paid-up share capital is at least equal to the repayment, the repayment of capital will not be subject to Canadian tax.
- Canadian subsidiary should still be able to deduct the interest incurred with respect to the borrowing, although this would need to be looked at by tax lawyers on a case by case basis.

III. OVERVIEW OF PERFECTING LIENS IN THE U.S. vs. CANADA

- Canada: each province has its own personal property security legislation with no uniformity (although some provinces are similar)
- U.S.: each state has adopted uniform legislation
  - Security interests in personal property and fixtures are governed by Article 9 of the "Uniform Commercial Code" of each state (for these purposes, referred to simply as the "UCC")
  - While each state technically has its own UCC, the key provisions are essentially uniform from state to state (since they were based on a national model)
  - The national model for Article 9 underwent significant revisions in 2001
  - Prior to 2001, Article 9 was analogous in many ways to the Ontario PPSA.

- After the revisions took effect in 2001, Article 9 set new rules for perfecting security that are different from Canadian jurisdictions (although Ontario has now proposed some amendments to its PPSA that will bring certain areas back in line with Revised Article 9, at least for intangible personal property)
- Article 9 now makes perfecting a security interest significantly easier than in Canada.
- The purpose of this presentation is to give a very brief summary of the differences between Article 9 and the Ontario PPSA <u>with respect to perfecting a security interest by filing a financing statement</u>
- Other means of perfection, such as by possession or control (which are similar on both sides of the border) will not be examined

- ***PERFECTION BY FILING A FINANCING STATEMENT - CONTENT***
- In both Canada and the U.S., filing a financing statement in the appropriate filing office is sufficient to perfect a security interest in most types of collateral
- **US Practice (differences from Canada)**
  - In the U.S., the form of financing statement is generally uniform from state to state and is referred to as a "UCC-1"
  - The collateral description in the UCC-1 must "reasonably identify" the collateral (there is no "check-the-box" collateral descriptions)
  - Under the UCC, the words "all assets" are a sufficient collateral description in a financing statement (if the collateral is comprised of all personal property now or hereafter acquired).
  - Notwithstanding this, the UCC-1 form permits you to annex a more detailed collateral description (i.e., if the description is longer than the words "all assets" or cannot otherwise fit in the space provided).

- The general practice in the US is as follows:
  - For a standard filing where the collateral includes all assets of a debtor, most law firms will now simply use the description “all assets” in box #4
  - Where the collateral is anything less than “all assets”, the secured party will typically annex the granting clause from the relevant security agreement, or in the case of equipment financing, the invoice listing a description of the item(s) of equipment being financed

- ***FINANCING STATEMENT – HOW LONG IS IT EFFECTIVE***
- **Canada**
  - Most Canadian jurisdictions allow for an unlimited registration period (i.e., you could register for infinity)
  - The market practice tends to be to register for a period that is at least 2 years longer than the maturity of the underlying loan
- **United States**
  - With limited exceptions, the UCC provides that any filing expires after five years and must be continued within the six month period prior to the end of the five-year period by the filing of a continuation statement in the prescribed form. You cannot specify a different duration.
  - Exceptions to this are for “public finance transactions” (i.e., secured high yield bonds with a maturity of 20+ years) or a “manufactured-home transaction”, which will permit a 30 year duration.

- If a financing statement lapses, the security interest perfected by the filing becomes unperfected and is deemed never to have been perfected as against a purchaser of the collateral for value (but not a lien creditor).
- Hence there is a strong impetus to stay on top of filings and to ensure that continuation statements are filed in a timely manner if necessary.
- This is particularly important in loan transactions where the maturity of the loan exceeds five years.

- ***WHERE TO FILE***
- This is probably the largest distinction between Canada and the US
- When Article 9 was revised, it eliminated the need to make multiple filings, even if assets are located in multiple jurisdictions
- **Canada**
  - For tangible personal property, it is still necessary to search and file in each province where tangible assets are located
- **United States**
  - For all property, only one filing is needed in the place of a debtor's "location" – the local law of a debtor's "location" is what governs perfection of a security interest
  - US entities that are "registered organizations (i.e., organized under the laws of a single US state, such as corporation or LLC) are "located" in their state of organization

- This becomes the mainstay of US practice – for most non-individual and non-foreign entities, you simply file in the state of organization

- Individual debtors are "located" in the state of their place of principal residence

- Foreign (non-US) debtors have special rules to determine where they are "located":

  - If the debtor is formed in a country that <u>does</u> have a sufficient filing system in place for UCC purposes, then they are located in the jurisdiction where the chief executive office / principal place of business is located (in practice, most debtors will not fall into this category since most lawyers will not opine on the sufficiency of a foreign filing system)

  - If the debtor is formed in a country that <u>does not</u> have a sufficient filing system in place, then they are deemed to be "located" in the District of Columbia (this is why a D.C. filing will often be made for Canadian entities involved in cross-border transactions)