Asset-Based Lending

RECENT DEVELOPMENTS OF IMPORTANCE

R.D. Jeffrey Rogers
Waël Rostom
McMillan Binch Mendelsohn LLP

Introduction

Against a backdrop of high growth, competitive pressure, reduced pricing and more aggressive deal structures in the Canadian asset-based lending market, some of the current legal developments in Canada in this area may present both opportunities and challenges for asset-based lenders. This article offers first a brief overview of the current Canadian market trends in asset-based lending, followed by a basic general overview of the Canadian legal framework for asset-based lenders, and, third, a more in-depth discussion of some of the recent legal developments of relevance to asset-based lenders.

Current Market Trends

According to the 2006 Annual Asset-Based Lending Survey of the Commercial Finance Association, the total volume of asset-based loans outstanding in the United States in 2006 was $489.3 billion, an increase of 16.5 percent over 2005.[1] While the statistics for 2006 for Canada are not yet available at the time of writing, the general consensus among market participants is that the market in Canada is continuing to grow at a similar pace.[2] The growth is being fuelled by continued entry of new US asset-based lenders (both banks and finance companies) into the Canadian market, the establishment of asset-based lending divisions by several Canadian banks and the increasing market acceptance of asset-based loans as an alternative form of finance for large leveraged loan deals, particularly in asset-intensive industries. The continued growth of asset-based lending in Canada will be further enhanced by the much-anticipated elimination of Canadian withholding tax on interest paid to arm's length foreign lenders, now expected to occur in early 2008.[3]

Traditionally viewed as a financing alternative to cash flow loan products for distressed companies, a pure asset-based loan product offers debtors the ability to leverage their assets on a liquidation value basis. While asset-based lending is often biased toward current assets, lenders may provide asset-based financing for fixed assets as well. This form of financing is particularly attractive to stressed companies with weak or negative earnings, seasonal instability or problems refinancing public debt due to ratings downgrades or covenant defaults. Asset-based loans typically require no more than one or two non-leverage-based financial covenants, and in some cases, none at all, so long as minimum availability (i.e., collateral coverage) thresholds are met. For this reason, asset-based loan structures can also be attractive to relatively healthy companies in seasonal or cyclical industries, where exposure to commodity prices or currency exchange rates can be problematic in an economic downturn.

While the Canadian ABL market has grown in size, it has also become a more competitive and complex marketplace, reflecting developments south of the border. The convergence of asset-based lenders and cash-flow lenders on lending opportunities, the greater participation of hedge funds and private equity funds in both the senior and second lien market, and competitive pricing between asset-based loans and conventional senior debt financing, have resulted in greater liquidity throughout the market. In some cases, the response of lenders has been to move toward hybrid financing structures where the asset-based loan structure is being employed more aggressively, often relying on an enterprise value analysis in order to leverage non-traditional assets, or achieve higher effective availability.

Overview of Canadian Legal Regime Applicable to Asset-Based Lending

In Canada, provincial (state) legislation generally governs the creation of security while the federal government has exclusive constitutional authority to legislate with respect to "bankruptcy and insolvency."

Taking Security in Canada

Provincial registry and land title systems govern security against real property, and provincial personal property security legislation governs security against personal property. Most Canadian provinces have adopted comprehensive personal property security legislation ("PPSA") resembling Article 9 of the *United States Uniform Commercial Code* ("UCC"). The PPSA regulates the creation, perfection and enforcement of a security interest in a debtor's assets and creates a system for determining the priority of certain competing interests in collateral. The Act applies to any transaction that creates a security interest in personal property, regardless of the form of document used to grant the interest. Québec, Canada's only civil law jurisdiction, has a European-style *Civil Code* that codifies the province's general principles of law. Québec now has a system for registration and enforcement of security in property that is functionally similar to the PPSA in many respects. Despite these basic similarities, the Québec legal system relating to the granting and enforcement of security is different from the common law in many ways, and lenders should consult with Québec counsel where Québec assets or borrowers are involved in any transaction.

Priming Liens

In Canada, a number of statutory claims may "prime" or take priority over a secured creditor. Priming liens commonly arise from a debtor's obligation to remit amounts collected or withheld on behalf of the government (e.g., unremitted employee deductions for income tax, Canada pension plan contributions and employment insurance premiums and unremitted federal goods and services taxes and provincial sales taxes), or the debtor's direct obligations to the government (e.g., municipal taxes and workers' compensation assessments).

Guarantees

Canadian laws governing intercorporate

guarantees are quite different from their US counterparts. Generally speaking, the validity of an intercorporate guarantee is less likely to be successfully challenged under bankruptcy, fraudulent conveyance or preference legislation. In many jurisdictions in Canada, corporate laws now permit a corporation to give financial assistance by way of guarantee or otherwise to any person for any purpose, provided it discloses material financial assistance to its shareholders after such assistance is given. However, the corporate laws in certain provinces continue to prohibit financial assistance to members of an intercompany group if there are reasonable grounds to believe that the corporation would be unable to meet prescribed solvency tests after giving the assistance, subject to specified exceptions. Under certain circumstances, granting a guarantee in a manner that disregards the interest of creditors or minority shareholders could be challenged under the oppression provisions of Canadian corporate legislation.

Enforcement of Creditor's Rights— Receivership

Historically, secured creditors have often enforced their security through the appointment of a receiver. A receiver may either be appointed privately (by contractual right under the security agreement) or by court appointment under provincial law or the *Bankruptcy and Insolvency Act* ("BIA"). A receiver can be authorized to operate the business of a debtor where it is necessary or advisable; for example, to complete a key contract or to complete work-in-process or to sell a business as a going concern. This type of receiver (whether privately appointed or court-appointed) is referred to as a receiver-manager.

Bankruptcy

The BIA contains provisions that are analogous to Chapter 7 proceedings in the US. A bankruptcy stays the rights of all creditors, except secured creditors. A trustee-in-bankruptcy (a licensed chartered accountant) is appointed and all of the debtor's assets vest in the trustee, subject to the rights of secured creditors. Secured creditors are generally not affected by the bankruptcy stay and are entitled to exercise their rights over the collateral for which they have a valid and perfected security interest. The existence of a bankruptcy can be a useful tool for secured creditors, as the relative priority of certain statutory "priming lien" claimants and landlords are reversed by the debtor's bankruptcy.

Restructurings

In Canada, both the BIA and the *Companies' Creditors Arrangement Act* ("CCAA") allow certain types of debtors to reorganize their affairs. Proceedings under both statutes are primarily debtor-driven and are somewhat analogous to Chapter 11 proceedings in the US. Each Act stays creditors from enforcing their claims, subject to certain exceptions.

Legal Developments — Elimination of Cross-border Withholding Tax

On September 21, 2007, Canada and the United States signed the widely anticipated 5th protocol (the "Protocol") to the Canada-US Tax Treaty (the "Treaty"). Once it has been ratified by both countries, the Protocol will ultimately eliminate withholding tax on conventional interest payments made by Canadian taxpayers to US residents. The eventual elimination of this withholding tax will create more opportunities for US and Canadian asset-based lenders alike: "This is good for business, consumers and the Canadian economy," said Nancy Hughes Anthony, President and Chief Executive Officer of the Canadian Bankers Association. "The elimination of this tax will result in increased investment, reduced cost of capital, and more efficient North American capital markets. It is the right move."

Background

Under the *Income Tax Act* (Canada), non-resident lenders are generally subject to a 25% tax on the gross amount of interest they collect from Canadian resident borrowers. Non-resident lenders that are entitled to the benefits of an income tax treaty are generally subject to a reduced rate of 10% on such interest payments. The law requires the Canadian borrower to withhold the tax from payments made to the lender and remit the tax to Canada's taxing authority, the Canada Revenue Agency. Withholding tax can be a significant factor in structuring transactions and can influence whether debt is raised wholly in Canada or wholly or partly outside Canada.

Withholding Tax

The *Income Tax Act* (Canada) currently provides a limited number of exemptions for non-resident withholding tax on interest payments. One of the most significant exemptions is the "5/25 exemption" that generally applies if a loan is between arm's-length parties, the term of the obligation is greater than five years and no more than 25 per cent of the principal amount of the loan is required to be repaid within five years (except through the failure or default of the borrower). However, the utility of the 5/25 exemption is limited because it applies only to long and medium-term debt and it does not apply in the case of revolving credit.

In practice, where a withholding tax exemption is not available, withholding tax on interest payments is an additional financing cost, which is either borne by the non-resident lender, or passed on to the Canadian borrower by means of a "gross-up" clause in the loan document. The "gross-up" clause basically requires the borrower to pay additional interest to compensate for the withholding tax. This can represent a significant transaction cost to the parties and it can make transactions with non-resident lenders less competitive than transactions with domestic lenders.

Eliminating Withholding Tax on Interest

The Protocol will enter into force once it has been ratified by both the Canadian and

United States governments. The Government of Canada intends to proceed with a Bill at the earliest opportunity. The earliest date on which the Protocol could enter into force is January 1, 2008. This would require both countries to ratify the Protocol in 2007. The Canadian government has announced that upon ratification of the Protocol, the *Income Tax Act* (Canada) will also be amended in order to eliminate the withholding tax on interest paid to all arm's length non-residents, regardless of their country of residence.

The proposed changes should be welcomed by both lenders and borrowers in Canada. The result in many cases will be to lower the cost of borrowing for Canadian borrowers that borrow from US lenders. The change should also facilitate greater access to foreign debt financing by Canadian borrowers, increase liquidity for Canadian lenders and may introduce additional competition in the Canadian corporate debt markets. However, US lenders contemplating greater access to the Canadian market should take note that the Protocol does not eliminate all of the obstacles for US lenders that want to lend into Canada – there are regulatory restrictions that should not be overlooked.

Regulatory Restrictions on a "Foreign Bank" Carrying on Business in Canada

Under the *Bank Act* (Canada), a "foreign bank" shall not engage in or carry on business in Canada except as authorized by the Act (i.e. through a foreign bank subsidiary or an authorized foreign branch or some other approved entity). The term "foreign bank" is broadly defined in the Act to include any entity that is called a bank or that is regulated as or like a bank. It also includes any entity that controls a foreign bank and any entity that provides financial services and is affiliated with a foreign bank.

This prohibition against engaging in or carrying on business in Canada would not prohibit a foreign bank from making a loan to a Canadian borrower as long as the nature and extent of all the foreign bank's activities in Canada do not amount to engaging in or carrying on business in Canada. Whether a foreign bank would be considered to be engaging in or carrying on business in Canada by reason of making a particular loan to a Canadian borrower would depend on all the surrounding circumstances. Some of the factors that could be relevant include: how the relationship between the foreign bank and the Canadian borrower arose; where the documentation was negotiated and executed; and where the transaction was closed. Generally, where all aspects of the marketing, negotiation, execution and closing of a loan transaction by a foreign bank took place outside Canada, the foreign bank would not be considered to be engaging in or carrying on business in Canada solely by reason of that loan transaction.

Legal Developments— Insolvency Law Reform

Asset-based lenders doing business in Canada should be aware of the pending enactment of legislation that will materially amend Canada's insolvency laws. In November of 2005, Parliament and the Senate passed *Bill C-55* (now Chapter 47 of the Statutes of Canada, 2005), which contained significant, detailed amendments to the BIA and the CCAA. The process to enact Chapter 47 was rushed and gave rise to a significant number of issues both of a substantive and of a drafting nature. As a result, the proclamation of Chapter 47 was delayed to allow time for a detailed review. The legislative review process resulted in the introduction of *Bill C-62* which was intended to make numerous amendments to Chapter 47. It was expected that the Senate would hold hearings on *Bill C-62* in the fall of 2007 but its status is currently uncertain. For the purposes of this article, the forgoing legislation to potentially amend Canada's insolvency laws are referred to collectively as the "Amending Legislation".

The following core elements of the Amending Legislation are worth reviewing from the perspective of asset-based lenders.

Wage and Vacation Pay Lien

The Amending Legislation provides an employee of a bankrupt employer, or of an employer in receivership, with a superpriority charge on the employer's "current assets" for wages and vacation pay (but not for severance or termination pay). This charge will secure unpaid wages and vacation pay for the six-month period prior to bankruptcy or receivership to a maximum of $2,000 per employee (plus up to $1,000 for disbursements by "traveling salespersons"). The superpriority charge ranks ahead of all other claims except unpaid supplier rights.

Asset-based lenders lending on the security of operating assets (inventory and receivables) will have to decide if the new statutory priority for wage and vacation pay arrears merit any additional reserves in borrowing base calculations. At present, in bankruptcy, wages and vacation pay are in theory subordinate in priority to secured creditors' claims. However, in practice it is usual to pay payroll arrears for a variety of practical reasons in insolvency proceedings, including the need to secure employee cooperation and because of the personal liabilities of directors. Current practice with respect to vacation pay is more variable.

Pension Contributions Lien

The Amending Legislation also grants a superpriority charge in bankruptcies and receiverships for outstanding current service pension plan contributions, ranking behind the employee remuneration superpriority but otherwise with the same priority as is accorded to that lien but unlimited in amount. The pension contribution superpriority extends to all assets, not just current assets.

In essence, the charge will secure (1) amounts deducted as pension contributions from employee wages prior to a bankruptcy or receivership but not contributed to the pension fund and (2) amounts required to be contributed by the employer either to a defined contribution pension plan, or to a defined benefit pension plan for current service. The superpriority does not extend to unfunded deficits arising upon a windup of a defined benefit plan or to catch-up or special payments.

The existence of the lien will enhance the importance of effective reporting and monitoring of pension contributions by the borrower, as well as other employee obligations such as vacation pay.

Thirty-Day Goods

Currently under the BIA, an unpaid supplier of goods that fits within specified parameters (e.g., goods that are identifiable and have not been resold) may be entitled to repossess those goods. The right arises if, within 30 days of delivery of the goods, the purchaser becomes bankrupt or subject to receivership and the supplier makes a written demand for their return.

The Amending Legislation slightly modifies the 30-day provisions. It makes a mechanical change that will give unpaid suppliers a modest amount of additional time to claim the lien by changing the period within which the unpaid supplier's demand must be delivered to 15 days from the commencement of the bankruptcy or receivership. In addition, it restricts the use of "interim" receivers (whose appointment does not necessarily trigger 30-day goods claims).

However, it is not anticipated that in most cases such amendments will materially increase the recoveries by unpaid suppliers.

Debtor-in-Possession ("DIP") Financing

In recent years, notwithstanding the absence of specific statutory authority, courts have granted orders authorizing borrowing and the granting of security by debtors subject to CCAA proceedings. The Amending Legislation would codify that practice under the CCAA and expressly authorize it under the commercial proposal provisions of the BIA.

The method of codification will arguably make it easier for borrowers that file for protection under the CCAA or the proposal provisions of the BIA to obtain DIP financing on a priming basis without the consent of the existing secured lenders and, therefore, increases the risk to asset-based lenders in hostile situations. On the other hand, for lenders interested in providing DIP financing in Canada, the changes may facilitate greater opportunities in this area. For example, the Amending Legislation provides that:

- on application by a debtor and on notice to the secured creditors who are likely to be affected by the security or charge, a court may authorize that all or part of the debtor's property is subject to a priming DIP; and
- while the Amending Legislation sets out a number of factors that a court must consider, there is no provision that requires that there be adequate protection for, or no material prejudice to, a secured creditor being primed by the DIP.

Other Court-Ordered Liens

The Amending Legislation also expressly authorizes a court in both BIA proposals and CCAA proceedings to grant, on notice to the secured creditors who are likely to be affected, various additional charges in priority over the claims of secured creditors, including:

- a charge to secure payment of fees and costs (including legal costs) incurred by trustees, receivers or CCAA monitors, as well as any financial, legal or other experts engaged by the debtor and potentially by other "interested" parties (e.g., creditors' committees and unions); and
- if in the court's opinion adequate insurance is not available at a reasonable cost, a charge on the debtor's assets in favour of directors and officers to indemnify them against obligations or liabilities that they incur postfiling in acting as a director or officer of a debtor involved in a proposal or CCAA proceedings.

The effect of codifying the DIP provisions and expressly authorizing the additional charges could be to make it more difficult to oppose DIP financing and the administrative costs of an insolvency proceeding being financed in priority to existing secured creditors' rights. This may give secured creditors less negotiating leverage in the run-up to restructuring filings and during restructuring proceedings.

Statutory Power of Sale

The Amending Legislation expressly empowers the court to authorize an insolvent person to sell or otherwise dispose of assets outside the ordinary course of business with court authorization. This could involve the debtor's entire business. The proposed amendments contain a number of factors to be considered by the court when deciding how to exercise its discretion. However, the fact that the sale involves the collateral of a secured creditor for proceeds that will be insufficient to pay out the secured creditor is not one of those factors. As a result, the provisions increase the risk of a secured lender losing control of its collateral in a restructuring proceeding.

Executory Contracts

The Amending Legislation introduces a statutory regime whereby an insolvent debtor may sell or disclaim executory contracts. The provisions are rudimentary as compared to the provisions of US bankruptcy law. However, there may be circumstances where an asset-based lender can indirectly benefit from them. For example, these provisions may enable a business that depends on ongoing contracts to be sold without the consent of the counterparties to the contracts. While the counterparties to the contracts will have the right to challenge the sale in court, that may in practice prove to be ineffective.

Legal Developments— Successor Employers

Recent case law has heightened concerns about trustees and receivers becoming personally liable as successor employers for obligations of the debtor such as wages, vacation pay, severance and termination pay and pension claims. Successor employer liability is primarily a risk where the borrower has a unionized workforce and is party to a collective bargaining agreement. The liability can arise by virtue of a receiver taking possession and control of the assets of a business and operating it in the hope of selling it on a going-concern basis, only to fail with the result that the assets are liquidated. Asset-based lenders are impacted by this personal liability risk either because of indemnities given to the receiver or because personal claims against the receiver are paid out of the proceeds of realization in priority to the distributions to the secured creditors.

The concern has always been that in the event of a failed going-concern sale attempt by a receiver who took possession and control of the business, the union would bring an application to the applicable labor relations board for a declaration that the receiver is "successor employer." To protect against such risk, until recently, receivers routinely obtained court orders that purported to effectively immunize them from successor employer declarations. These orders were virtually always obtained without notice to the employees or unions and were usually granted. Furthermore, where a stay of proceedings had been issued in a bankruptcy, the union was required to first seek leave from the bankruptcy court to commence a proceeding for a successor employer declaration. Courts often denied leave to the union indefinitely.

However, the Supreme Court of Canada's decision in *GMAC Commercial Credit Corporation and T.C.T. Logistics Inc. et al v. Wood & Allied Workers of Canada, Local 700*,[4] has removed these protections and procedural barriers. First, the Supreme Court ruled that a bankruptcy court did not have the jurisdiction to make declarations that the receiver was not a successor employer and that the determination of whether or not a receiver was successor employer was within the exclusive jurisdiction of the Ontario Labour Relations Board. Second, with respect to leave applications, the Supreme Court held the test to be a low one, with leave to be refused primarily in situations where the claim is "frivolous, vexatious" or "manifestly unmeritorious."

Following *TCT Logistics*, receivers given a mandate to run the debtor's business now must more closely consider the adequacy of section 14.06(1.2) of the BIA, which was designed to insulate receivers from substantive liability for prereceivership successor employer liabilities. There is some concern that the current language of s. 14.06(1.2) was not adequately drafted to achieve this result. Chapter 47 attempted to address the existing drafting deficiency in the BIA. However, the proposed amendment was generally viewed as inadequate by insolvency practitioners. *Bill C-62* included a further amendment to s. 14.06(1.2) of the BIA. Under *Bill C-62,* a receiver (or trustee) who carries on the business of the debtor or continues the employment of the debtor's employees is protected from personal liability for the employer's obligations that existed before the receiver's appointment or that are calculated by reference to a period before the receiver's appointment. It is hoped that the *Bill C-62* amendment, if enacted, will finally achieve the original desired result of protecting receivers from personal liability for pre-receivership employer liabilities.

As a result of *TCT Logistics*, when dealing with unionized companies with collective bargaining agreements, asset-based lenders will need to review the facts and circumstances of each case to determine the best way to recover their loans. There are structures by which a lender may be able to obtain substantially the same benefit as a receivership without incurring material successor employer risk. If the amendment contained in *Bill C-62* is passed, it is expected that creditors and insolvency practitioners will be more open to operating receiverships. However, it will remain to be seen how new section 14.06(1.2) of the BIA is interpreted by labor boards and the courts in subsequent litigation.

In Conclusion

The legal developments in Canada discussed above present both opportunities and challenges for asset-based lenders. The proposed changes to Canada's tax laws will promote further integration of the US and Canadian asset-based lending markets and should increase both awareness and availability of asset-based lending as a product in Canada. While proposed changes to insolvency regime will be beneficial by facilitating going-concern solutions and encouraging greater consistency in proceedings across the country, some of the changes will also present challenges for asset-based lenders. Lenders will likely want to (1) re-examine reserves and reporting requirements for certain priority claims when calculating a borrower's borrowing base; (2) consider addressing new issues with respect to employee claims in intercreditor agreements; and (3) assess the impact of the increased risks to secured lenders in reorganization proceedings. n

1. http://www.cfa.com/documents/ Annual_ABL_Factoring_Survey_2006.pdf.
2. See The Canadian Institute's 8th Annual Conference in Commercial Loan Finance and Security (March 1–2, 2006).
3. See the recent Tax Law Bulletin at http://www.mcmbm.com/upload/publication/newprotocols_0907.pdf.
4. *GMAC Commercial Credit Corporation and T.C.T. Logistics Inc. et al v. Wood & Allied Workers of Canada, Local 700* [2006] S.C.C. 35 [hereinafter "TCT Logistics"].

R.D. Jeffrey Rogers, *McMillan Binch Mendelsohn LLP*
Tel: (416) 865-7818 • Fax: (647) 722-6742 • E-mail: jeff.rogers@mcmbm.com

Partner and member of the firm's Corporate Financial Services Group. Jeff practises business law with a focus on debt financing transactions including syndicated lending, leveraged acquisition financings, tender offer financing, asset-based lending, second lien, private placement and subordinated debt offerings. He routinely acts for major Canadian and foreign financial institutions and borrowers on domestic and cross-border transactions. Highly regarded in the area of Banking and Finance law, Jeff often speaks at conferences and client in-house training programs on credit agreements and secured lending. He has been recommended in Banking and Finance law in *Chambers Global Guide, Best Lawyers in Canada* and The *Canadian Legal Lexpert® Directory*. He was also recognized in *Lexpert®* Magazine as one of the Top 40 Lawyers Under 40.

Waël Rostom, *McMillan Binch Mendelsohn LLP*
Tel: (416) 865-7790 • Fax: (647) 722-6736 • E-mail: wael.rostom@mcmbm.com

A partner of the firm's Corporate Restructuring Group. Waël has a commercial practice focusing on bankruptcy and insolvency, corporate restructurings, workouts, financings, secured lending transactions, the purchase and sale of distressed businesses and distressed loans and other forms of distressed investing, including DIP financings. Involved in numerous high profile domestic and cross-border insolvency and restructuring proceedings. Advised banks, financial institutions, hedge funds, private equity funds, asset based lenders, directors and officers, shareholders, customers and suppliers in significant restructuring proceedings. Also advised privately appointed and court appointed receivers, trustees in bankruptcy and court appointed monitors in properly and effectively discharging their statutory and other duties. Member of American Bankruptcy Institute, Turnaround Management Association, Loan Syndications and Trading Association – Firm Representative.