Asset Securitization

RECENT DEVELOPMENTS OF IMPORTANCE

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Introduction

The securitization market in Canada is busy and growing, as it continues to trade in products backed by the "big five" asset classes: auto, credit card, residential mortgages, commercial mortgages and collateralized debt obligations ("CDOs"). Dominion Bond Rating Service Ltd. recently estimated the total face amount of outstanding Canadian asset-backed securities to be at least $125 billion and reported a respectable growth of $45 billion during 2005.[1]

Securitization in Canada experienced some interesting developments in 2006 from both a deal flow and a legal perspective. What follows is a brief discussion highlighting some of those developments. The leading legal news was the Supreme Court of Canada's blessing of Canada's first court decision that considers the indicia of a legal "true sale" in Canada in the context of a sophisticated securitization transaction. Other developments include the maturation of the commercial mortgage-backed securities ("CMBS") market and the corresponding growth of commercial defeasance, as well as the growth of CDOs in terms of both volume and sophistication.

CDOs

The growth in Canadian asset-backed securities in recent years has been driven to a large extent by the increasing use of CDOs and other credit derivative products. Such structured products now comprise approximately 28% of all outstanding asset-backed commercial paper. Unlike traditional securitizations, many credit-linked products are synthetic transactions that enable parties to gain exposure to diverse portfolios of reference assets without having to physically acquire those assets.

Accounting Developments

The Canadian securitization market has been keeping a close eye on developments in U.S. accounting treatment of securitization. Canadian accounting guidance will no doubt continue to follow and be largely based on the statements and interpretations of the U.S. Financial Accounting Standards Board ("FASB"). Canada's Accounting Standards Board (the "AcSB") is not expected to release for public comment any draft amendments to Accounting Guideline AcG-12, *Transfers of Receivables*, prior to the release of the corresponding exposure draft of the Statement of Financial Accounting Standards No. 140, *Accounting for Transfers of Financial Assets and Extinguishment of Liabilities* ("FAS 140"), anticipated in the second quarter of 2007. The amendments to AcG-12 and FAS 140 will, among other things, review the permitted activities of qualifying special purpose entities. In any event, the AcSB has indicated that it intends to maintain convergence of AcG-12 with FAS 140 and that the amendments to AcG-12 will correspond to those being developed by FASB.

True Sale in Canada

Considered a landmark decision by securitization lawyers, the 2003 trial judgment in *Metropolitan Toronto Police Widows and Orphans Fund et al v. Telus Communications Inc.*[2] (the "BC Tel" case) provided a useful checklist of criteria that a Canadian court must consider to determine whether the transfer of financial assets is a "true sale" such that the transfer puts such assets beyond the reach of the seller's creditors, or a secured loan disguised as a sale, which would not. In June 2005, the Ontario Court of Appeal reversed the trial decision but did not interfere with the trial judge's true sale analysis or with his finding that a complex securitization of trade receivables did indeed involve a true sale of the financial assets. In January 2006, the Supreme Court of Canada denied leave to appeal, thus leaving the court of appeal's decision as Canada's only appellate consideration of what constitutes a true sale in a modern securitization.

The facts of the case were simple. BC Tel had issued redeemable bonds, bearing interest at 11.35% per annum under a trust deed that contained a "no financial advantage covenant" ("NFAC") prohibiting BC Tel from redeeming the bonds "by the application, *directly or indirectly, of funds obtained through borrowings*, having an interest cost to [BC Tel] of less than 11.35% per annum."

Later, BC Tel entered into a receivables purchase agreement pursuant to which it sold certain trade receivables to a multiseller commercial paper conduit (RAC Trust) for an initial cash payment of $150 million, which the conduit raised by issuing commercial paper at a rate significantly lower than 11.35% per annum. BC Tel then used the proceeds to redeem the bonds. The plaintiffs, who owned some of the bonds, sued, alleging that the redemption breached the NFAC either as (1) a direct borrowing by BC Tel through a loan disguised as a sale or (2) as an indirect borrowing through applying the proceeds of the sale that were raised through the issuance of the commercial paper. It was the former allegation that was most troubling, because the structure of the receivables purchase agreement used in the RAC Trust transaction resembled many other existing revolving receivables purchase facilities in Canada. A finding that the "sale" of receivables under such a structure should be recharacterized as a loan could have struck a near-fatal blow to the Canadian securitization market: the legal isolation of the transferred assets from the credit risk of the seller that arises from a true sale drives many of the financial and accounting benefits sought to be obtained from securitization, including a lower cost of funds and balance sheet enhancement. A true sale opinion is accordingly a *sine qua non* of most deals.

In approaching the characterization issue, the trial judge listed seven factors that a court must consider in determining whether a transfer of financial assets is a sale or a loan:

- the intention of the parties as evidenced by the language of the agreement and subsequent conduct;
- whether the risks of ownership are transferred to the purchaser and the extent and nature of recourse to the seller;
- the right of the seller to surplus collections;
- certainty of determination of the purchase price;
- the extent to which the purchased assets are identifiable;

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- responsibility of the seller in the collection of the receivables; and
- whether the seller has a right to redeem the receivables on payment of a specified amount.

These factors have already become an authoritative checklist for what constitutes a true sale under Canadian law. However, some of the indicia are at odds with previous Anglo-Canadian authority and may mark a movement to a more U.S.-style approach to true sale issues.

Intention of the Parties

First, the intention of the parties must be clearly apparent, and such intention must be demonstrated by the language of the legal documentation and the conduct of the parties, both of which must be consistent with that of a purchase and sale. While the supposed intention of the parties is routinely invoked as the touchstone for the interpretation of contracts generally, a somewhat surprising statement in the trial judge's remarks is that to discern that intention the court must "look to the substance of the transaction and not merely the form." This may mark a shift from the traditional Anglo-Canadian true sale analysis, which attached considerable weight to legal form and had little to say about economic substance.

Recourse

The trial judge also accepted the view that for a transaction to qualify as a true sale the seller must transfer the "ownership risk" to the purchaser. Following the transfer, the purchaser is expected to bear the risk of nonpayment with little or no recourse to the seller. Interestingly, and perhaps surprisingly, the authorities cited as the basis for these propositions are from the U.S., not England or Canada. The trial court also accepted an alternative theory advanced by U.S. academic Stephen Schwarcz and others,[3] which is that it is not the *degree* of recourse that should matter but rather its *kind*. Under this theory there are two kinds of recourse: recourse for "collectibility" and "economic recourse." Recourse for collectibility is essentially an indemnity or warranty given by the seller that the receivables will be good and collectible. This sort of recourse is said to be compatible with a true sale even for the full amount of the receivables, since in other contexts it is not uncommon for the seller of an asset to provide a warranty as to its performance. What is not compatible with a true sale is economic recourse, whereby the seller agrees to pay the purchaser a specified rate of return on a specified amount, regardless of how the underlying assets actually perform, since this begins to look very much like interest on a loan. Thus, Canadian law with respect to recourse seems to be that economic recourse is not consistent with a true sale, while at least some degree of recourse for collectibility is.

However, distinguishing between the two kinds of recourse may not be an easy task in practice. Moreover, by endorsing the view that any kind of recourse is relevant to true sale characterization, the court in *BC Tel* seems to have abandoned a long line of Anglo-Canadian authority that minimized or disregarded its relevance. The result may be less, rather than more, legal certainty.

Rights to Surplus Collections

Based on an English authority that a right to surplus does not per se turn a sale into a loan, the trial judge ruled without elaboration that the absence of a right to retain the surplus from the collections of accounts receivable is not fatal to concluding that a transaction is a true sale.

Certainty of Purchase Price

To be consistent with a purchase and sale, the purchase price of the receivables must be determinable with certainty on any given day. Interestingly enough, although the term "purchase price" was not actually defined in the RAC Trust receivables purchase agreement, the court nevertheless found enough evidence of intention of how it should be determined to conclude that its calculation was sufficiently certain.

Identifiability of the Purchased Assets

To establish a true sale, the parties must be able to identify with certainty the assets that are the subject matter of the sale. While this proposition may seem self-evident, in a revolving securitization of trade receivables, the asset pool and the interest of the purchaser therein fluctuate from day to day, making identifying any particular asset or the quantum of that interest not entirely straightforward. Yet because under the RAC Trust agreement the composition of the asset pool could be ascertained at least in principle on any given day, the trial judge found that this condition was satisfied.

Equity of Redemption

One feature that distinguishes an absolute sale and transfer of property from a security interest is that with the latter, the original owner of the property retains a proprietary interest in the property that entitles such owner to reclaim it upon repayment of the debt that it secures. In other words, almost by definition the grantor of a security interest retains an "equity of redemption" in the property transferred, whereas a seller does not. For a transaction to qualify as a true sale, the seller must not retain any right to reacquire the assets in exchange for a specified amount. The trial judge in *BC Tel* found no evidence of such a requirement.

Servicing Responsibility

Often, a securitized sale of receivables includes as part of the consideration the continued servicing and collection of the receivables by the seller. In *BC Tel* the court found that such continuing involvement by the seller with the portfolio of sold receivables is not inconsistent with a true sale.

The Court of Appeal Decision

The decision of the Ontario Court of Appeal in *BC Tel* is in some respects disappointing in that it does not offer a definitive appellate treatment of the true sale issues. Since the court of appeal accepted the plaintiff/appellants' submission that the application of sale proceeds involved an *indirect* borrowing, it was unnecessary for the purpose of deciding the case to embark on a principled discussion of the true sale issues, which related only to *direct* borrowing. Thus, the court of appeal understandably gave true sale issues somewhat short shrift, regrettably leaving in doubt the extent to which the list of indicia proposed by the trial judge

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should be regarded as authoritative. Nevertheless, the list will likely remain a useful guide to what constitutes a true sale in Canada for some time to come.

Commercial Defeasance: Slowly but Surely

As the CMBS market in Canada has matured, it has started to experience a growth in defeasance transactions.

Briefly, defeasance is a transaction by which a pledge of high-quality securities such as government of Canada bonds is substituted for mortgage security over a commercial property. Where the lender sells its interest in a mortgage loan (and its interest in the property pledged as security for that loan) to a conduit under a CMBS transaction, and, subsequently, the mortgage borrower wishes to dispose of or refinance the mortgaged property, the mortgage documents typically provide that before the lender releases its lien the borrower must first replace the mortgaged property with substitute collateral through a defeasance transaction. Although well known in the U.S., defeasance transactions have only recently come into their own in Canada, more so as CMBS occupies an increasingly larger share of asset-backed issuances.

The defeasance transaction is documented under a defeasance pledge and security agreement that governs the relationship between the borrower (pledgor), the conduit as mortgage lender (or more typically, the custodian acting for and on behalf of the investors of the conduit), the master servicer (appointed under the CMBS transaction) and the securities intermediary (appointed to act as custodian of the pledged securities). Under this agreement, the pledgor agrees to pledge an amount of securities, usually government of Canada bonds, to the lender in exchange for the lender releasing its lien over the mortgaged property. The government of Canada bonds are selected such that each bond matures on or before a payment date, and the proceeds from the maturity of each bond are used to make the regularly scheduled payment due under the mortgage loan.

It is important to note that the lender *only* releases its lien over the mortgaged property so that the property becomes free and clear of the lender's liens to allow a purchase or refinance transaction. However, in Canada, defeasance does *not* release the borrower from the obligations under the mortgage loan. The obligations of the borrower, including the obligation to pay and all covenants not specifically related to the property (such as all events of default), continue to be operative until the final payment date under the mortgage.

A U.S. defeasance practitioner would generally recognize and understand typical Canadian defeasance documentation, but there are a few notable exceptions. First and foremost among these is that the Canadian practice does not generally permit the use of a "successor borrower" structure, as is common in the U.S. We understand that in the U.S. on a defeasance transaction, the loan obligation is typically transferred to a corporation controlled by the servicer (the "successor borrower"), and then the defeasance is completed. Once the obligation to pay is assumed by the successor borrower, the original borrower is released. From the borrower's perspective, the result of a U.S. defeasance operates like a discharge of the loan obligation. However, the U.S.-style successor-borrower transaction presents some potential difficulties under a Canadian CMBS conduit structure: a release of the original borrower and the novation of the loan to a new borrower may create potential tax liabilities for the bondholders.

A second notable difference stems from the nature of the defeasance collateral: nearly every Canadian defeasance transaction is completed using a pledge of government of Canada indebtedness. The result is that a borrower incurs a greater out-of-pocket cost in purchasing such securities compared to the cost of purchasing equivalent or nearly equivalent indebtedness issued by certain Canadian Crown corporations whose obligations may be backed by the government of Canada, either directly or by way of guarantee. Where an entity defeasing a loan in the U.S. has a number of issuers to choose from (each of whose bonds have yields higher than a plain vanilla Treasury certificate), in the Canadian market the underlying documentation and rating agency requirements limit the choice to a single issuer, namely the government of Canada[4].

As the market matures, the expectation is that the rating agencies will soon permit the underlying documentation to include defeasance collateral comprising either direct noncallable government of Canada debt, or obligations of or guaranteed by the government of Canada, which would include certain Canadian Crown corporations. The ability to purchase debt issued by Crown corporations should result in lower out-of-pocket expenses, especially where there remains a significant term to maturity for the mortgage loan. ■

1 Dominion Bond Rating Service, *2005 Year-End Review of Canadian Asset-Backed Securities.* Somewhat higher figures (C$130.2 billion and $46.9 billion, respectively) are reported in the Deutsche Bank–sponsored publication *Global Securitisation and Structured Finance 2006* (London, England: Globe White Page Ltd., 2006), p. 97.

2 (2003), 30 B.L.R. (3rd) 288 (Ont. C.J.); rev'd (2005) B.L.R. (4th) 251, 75 O.R. (3d) 784, 12 C.B.R. (5th) 251 (Ont. C.A.).

3 P. V. Pantaleo, H. S. Edelman, S. L. Schwarcz et al, "Rethinking the Role of Recourse in the Sale of Financial Assets" (1996), 52 *Business Lawyer* 159, cited at para. 47 of the *BC Tel* trial judgment.

4 On November 23, 2006, the Canadian federal government reiterated its pledge to eliminate federal net indebtedness by 2021 (http://www.fin.gc.ca/ec2006/speech/speeche.html). As federal debt levels fall, so do the incentives to issue new government of Canada indebtedness.

See bios on the following page.

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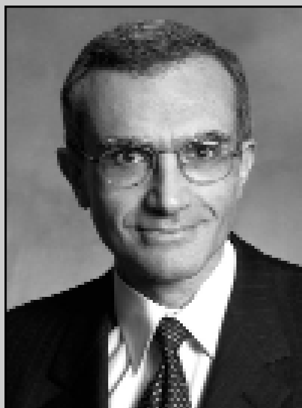

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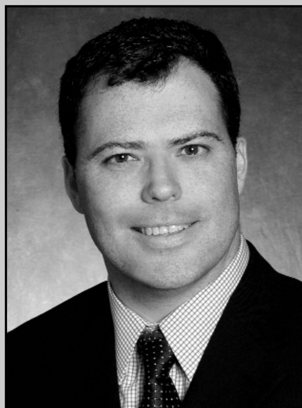

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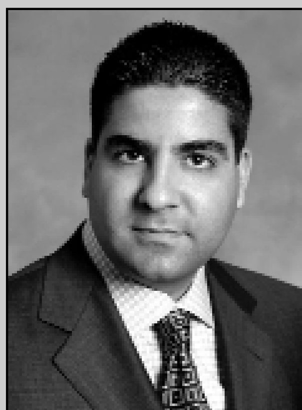
Partner in the firm's Debt Products Group. Practices in corporate finance and structured finance, including with respect to securitization and collateralized debt obligation transactions. Recent securitization experience includes the establishment of multi-seller commercial paper conduits. Acts on behalf of issuers, sellers, financial institutions, credit enhancers, liquidity lenders and servicers with respect to a variety of asset classes, including trade receivables, personal credit lines, commercial mortgages, vehicle loans, vehicle leases and collateralized debt obligations. Graduated, University of Western Ontario, B.A. – 1993; University of Toronto, LL.B. – 1998. Called to the Ontario Bar.



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Robert Antenore is a senior associate in the firm's Commercial Real Estate Group. Robert's practice covers all aspects of commercial real estate transactions from development to acquisitions and dispositions with an particular emphasis on secured lending. Robert is at the forefront of the developing practice surrounding commercial defeasance transactions and regularly acts for servicers across Canada. He is a participating member of the CMSA Committee on defeasance transactions in Canada with members of the CMBS industry and rating agencies. Robert acts for national and international financial institutions, commercial real estate companies, asset managers and pension funds. Before joining the firm in 2005, he practiced in the areas of real estate and commercial finance with a national Bay Street firm.

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