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• SECURED LENDING IN CANADA •

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Free trade and global competition have created new opportunities for U.S. businesses in Canada. As a result, both U.S. and Canadian businesses and financial markets enjoy far greater interaction. The following summarizes significant Canadian legal issues that a U.S. lender should be aware of when considering whether to underwrite or participate in a credit involving Canadian assets.

REGULATORY MATTERS

Under the *Bank Act* (Canada) S.C. 1991, c. 46, 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.

Under the federal regulatory framework, a foreign bank wishing to have a presence in Canada has several options. A qualifying foreign bank can carry on its wholesale banking business in Canada directly through a branch. The other options are the establishing of a foreign bank subsidiary or the maintaining of a representative office in Canada. The latter is limited to promoting the services and acting as a liaison with clients of the foreign bank. Foreign bank subsidiaries have the status of Canadian chartered banks and are regulated like their domestic counterparts. Foreign bank branches are regulated in a manner parallel to the domestic regulatory scheme.

TAX

WITHHOLDING TAX

Prior to January 1, 2008, under the *Income Tax Act* (Canada), R.S.C. 1985, c. 1 (5th Supp.), (the "*ITA*"), non-resident lenders were generally subject to a 25 per cent tax on the gross amount of interest they collected from Canadian resident borrowers (reduced to a ten per cent withholding tax on conventional interest payments to parties entitled to the benefits of the *Canada-United States Income Tax Convention (1980)*, as amended, the "*Canada-US Tax Treaty*"). Withholding tax was a significant factor in structuring transactions and could influence whether debt was raised wholly in Canada or wholly or partly outside Canada.

Effective as of January 1, 2008, the *ITA* was amended to eliminate Canadian withholding tax on conventional (*e.g.*, non-participating) interest payments made to arm's length non-residents of Canada, regardless of their country of residence. Furthermore, the recently-ratified Fifth Protocol to the *Canada-US Tax Treaty* eliminates withholding tax on conventional interest payments made after December 31, 2009 to non-arm's-length parties entitled to the benefit of such treaty (such payments made in 2009 would be subject to a four per cent withholding tax).

These amendments are welcomed by both non-resident lenders and Canadian borrowers. Canadian borrowers will particularly benefit where a withholding tax exemption would not otherwise have been available because they will no longer face demands to "gross-up" interest payments to compensate for the imposition of withholding tax. The new statutory changes will reduce transaction costs as the need for additional documentation and structuring to fit within an applicable withholding tax exemption has largely been eliminated. The changes also facilitate greater access to foreign debt financing by Canadian borrowers, increase liquidity for Canadian lenders and introduce additional competition in the Canadian corporate debt markets.

THIN CAPITALIZATION RULES

U.S. lenders sometimes lend to a U.S. corporation which, in turn, lends those funds to its Canadian subsidiary. Thin capitalization rules under Canadian tax legislation determine whether the subsidiary may deduct interest on the amount borrowed from the U.S. parent. Essentially, the rules prevent Canadian subsidiaries from deducting interest on the portion of loans from a U.S. parent that exceeds two times the subsidiary's equity (retained earnings and share capital and contributed surplus attributable to specified non-residents). The same rule applies equally to other interest-bearing loans to Canadian subsidiaries from "specified non-residents". The thin capitalization rules generally do not apply to a direct loan from an arm's length U.S. lender.

LEGISLATIVE FRAMEWORK FOR TAKING SECURITY

In Canada, provincial legislation generally governs the creation and enforcement of security. (A notable exception is security granted to banks under the federal *Bank Act*, discussed in greater detail below.) Provincial registry and land titles systems govern security against real property, whereas provincial personal property security legislation governs security against personal property.

PPSA JURISDICTIONS

Most Canadian provinces have adopted comprehensive personal property security legislation — *Personal Property Security Act* ("*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 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.

Under the *PPSA*, "security interest" is defined as an interest in personal property that secures payment or performance of an obligation. "Personal property" encompasses virtually all types of personal property. In most cases, the creditor perfects the security interest by registering a financing statement.

Most Canadian lenders in *PPSA* jurisdictions use a general security agreement covering all of the debtor's existing and after-acquired assets. A general security agreement typically does not extend to real property. Rather, a separate mortgage of lands commonly secures the real property. To create security in both real and personal property, the creditor may use a debenture which combines both a real property and personal property charge in the same document. Other security agreements may be limited to specific types of personal property, such as inventory, equipment or receivables.

NON-*PPSA* JURISDICTION

Quebec, Canada's only civil law jurisdiction, has a European style *Civil Code* that codifies the province's general principles of law. The hypothec, Quebec's main form of security, may be granted by a debtor to secure any obligation, and may create a charge on existing and after-acquired movable or immovable property. It may be made with or without delivery, allowing the grantor to retain certain rights to use the property.

BANK ACT SECURITY

Section 427 of the *Bank Act* provides a particular type of security available to only Canadian chartered banks and foreign bank subsidiaries incorporated under the *Bank Act*. The section entitles the bank to take security, from certain classes of debtors, against articles the debtor deals in, produces or uses in the course of its particular business. The debtor classes include manufacturers, wholesale or retail purchasers, shippers or dealers, and farmers, fishers and forestry producers.

When a bank takes security under the *Bank Act*, it must register the security with the Bank of Canada agent in the province where the debtor has its principal place of business. Before the security is granted, the bank must file a statutory form, the Notice of Intention to Grant a Security Interest. Once filed, s. 427 security is effective across Canada. Lenders may assign their rights and powers in respect of only certain types of property on which s. 427 security has been given.

A major advantage of *Bank Act* security is that it transfers title to the bank, thus allowing the bank to defeat certain claims that would otherwise take priority, such as a landlord's claim for unpaid rent. There is no clear code governing the relative priorities of competing *Bank Act* and *PPSA* security.

SELECTED ISSUES IN TAKING SECURITY IN CANADA

SECURITY IN GOVERNMENT RECEIVABLES

Under Canadian federal legislation, subject to prescribed exceptions, receivables owed by the federal government can be assigned only absolutely (not as security) and only with appropriate notice to the government, which must be acknowledged. Some provinces have similar legislation covering receivables owed by the provincial government. In Canada, asset-based lenders frequently exclude government receivables from the borrowing base. In cases involving significant Crown receivables, it may be possible to structure an indirect form of security.

SECURITY IN DEPOSIT ACCOUNTS

The *PPSA* permits a lender to take security over deposit accounts that are treated as receivables owed by the depository to the debtor owner. Consequently, lenders in Canada commonly take a security interest in the credit balance of a debtor's deposit account. The *PPSA* provides that security interests in deposit accounts are perfected by registering a financing statement.

LOCK-BOXES AND BLOCKED ACCOUNTS

Traditionally, Canadian debtors obtained working capital credit facilities on a demand basis from Canadian banks, which also served as the debtors' retail banks and cash management services providers. Where the Canadian lender also provided cash management services to the debtor, lock-box and blocked account arrangements served no purpose and were not used. However, two main factors changed this: the growth of asset-based financing by Canadian subsidiaries of U.S. banks and non-banks in Canada over the last 20 years, and the lock-box and blocked accounts arrangements that are conventional components of these financings. Through their participation in the establishment and operation of such arrangements, most Canadian banks are now familiar with lock-box and blocked account arrangements.

PLEDGES OF SHARES

Canadian lenders generally require debtors to pledge their shares if the debtor is a private company. Under the *PPSA* and the *Securities Transfer Act, 2006* ("*STA*"), versions of which are in force in most Canadian jurisdictions, a secured party can perfect its security interest in shares by registering under the *PPSA* or by taking control under the *STA* (or both). An interest perfected by control is superior to one perfected only by registration. For certificated shares, taking physical possession of the share certificates (endorsed, if applicable) meets the *STA* requirement for control. Control in other forms of investment property such as book-based securities can be achieved by other means under the *STA*, such as a control agreement with the relevant intermediary. In Ontario, the practice is to perfect by both control and registration. A private company's constating documents must include a restriction on the right to transfer its shares. This restriction usually states that each transfer of the company's shares requires approval by the company's directors or shareholders. In light of this restriction, pledged shares often are transferred into the name of the lender or its nominee to better perfect the lender's security in the private company's shares.

SECURITY IN REAL PROPERTY — TITLE OPINIONS

In Canada, lenders taking security on real property have the option of relying upon either title insurance or a title opinion from legal counsel. Title insurance, as a viable alternative, is a recent development in Canada and, although resort to title insurance is steadily increasing, title opinions are still more commonly used by Canadian lenders. A title opinion may be provided by counsel for the lender or the debtor and states that the debtor has a good and marketable title to the secured property, subject to encumbrances identified in the opinion.

LEGAL OPINIONS

Canadian lenders generally rely on the legal opinions of debtors' counsel as to the enforceability of loan and ancillary documents. Like U.S. counsel, Canadian counsel in practice do not provide opinions on the title to personal property or the priority of personal property security.

ENVIRONMENTAL LIABILITY

Secured lenders face three major risks under federal and provincial environmental laws. First, the debtor's financial stability may be threatened by environmental liabilities. Second, the debtor's environmental liabilities may impair the value of the lender's security. Finally, the lender may itself face exposure for environmental liabilities. This can arise if the lender actually participates in or exercises control over the day-to-day operations or financial management of the polluting business (before or after the appointment of a receiver), or becomes the owner of a contaminated site by foreclosure or similar action.

INTEREST ACT (CANADA)

Under the *Interest Act*, R.S.C. 1985, c. I-15 (Canada), any contract or agreement may stipulate or allow for any rate of interest. However, the contract or agreement must contain an annual interest rate or, in the case of contracts or agreements where the rate or percentage is for a period of less than one year, an express statement of the annual equivalent interest rate. Failure to include an annual interest rate or an annual equivalent interest rate will result in the imposition of an interest rate not to exceed five per cent per year. In addition, where contracts or agreements are secured by a mortgage on real property, a higher rate of interest cannot be recovered on amounts in arrears.

CRIMINAL CODE (CANADA)

Section 347 of the *Criminal Code*, R.S.C. 1985, c. C-46 (Canada) makes it a criminal offence to receive interest at a criminal rate, defined as an effective annual rate of interest that exceeds 60 per cent. Interest in the *Criminal Code* (Canada) is broadly defined to include interest, fees, commissions and similar charges and expenses that a borrower pays in connection with the credit advanced. This section has arisen almost exclusively in civil, not criminal, cases where the borrower seeks to avoid repayment by arguing that the contract was illegal. Courts have struggled with which, if any, contractual provisions should be enforced when a contract imposes a criminal rate of interest.

GUARANTEES

Canadian laws governing intercorporate guarantees are quite different from their U.S. 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.

ENFORCING SECURITY

Before enforcing security, a lender must demand that the debtor repay the loan, and give the debtor reasonable time to do so. The lender must comply with these requirements even if the debtor waived these rights in the loan and security documents. The secured lender (and any receiver it may appoint) must act in good faith and in a commercially reasonable manner when selling or otherwise disposing of the secured assets. The lender also must give advance notice of the intention to realize on security. If the lender fails to meet these obligations at any stage of the enforcement process, it may be liable to the debtor or other creditors for damages.

PRIORITIES ISSUES

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 (for example, unremitted employee deductions for income tax, 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 (for example, municipal taxes and workers' compensation assessments). The relative priority of statutory claimants and secured creditors is greatly affected, and often reversed, by the debtor's bankruptcy.

SUBORDINATED LIENS

In Canada, senior secured lenders commonly permit another lender to hold a subordinated security interest in the same collateral. However, the existence of a subordinated lien can complicate matters in a number of ways. First, should the senior lender realize on its security, it must do so in a commercially reasonable manner. The existence of a junior lender in no way alters that obligation. However, as a practical matter, another lender (other than the debtor or the debtor's unsecured creditors) is more likely to challenge the senior lender's actions. Moreover, the junior lender possesses certain technical rights that may otherwise affect realization (for example, notice of disposition of the collateral).

Finally, the junior lender might make it more difficult to successfully reorganize the debtor's debt. For example, corporate reorganization statutes divide the debtor's creditors into classes. Generally, the secured lender has an advantage by being in a class by itself, as this provides the lender with complete control. In most reorganizations, a senior and junior lender are placed in separate classes. However, under some circumstances the senior and junior lender may be placed in the same class. Additionally, a junior lender may ask the court to lift a stay, and thereby effectively end the reorganization attempt. The senior lender may prefer that the stay continue.

INSOLVENCY AND RESTRUCTURING

Canada's two principal insolvency statutes are the *Bankruptcy and Insolvency Act*, R.S.C. 1985, c. B-3 ("*BIA*") and the *Companies' Creditors Arrangement Act*, R.S.C. 1985, c. C-36 ("*CCAA*"). In Canada, reorganizations analogous to a Chapter 11 proceeding can be conducted under the *BIA* through that statute's proposal regime or under the *CCAA*. Liquidations akin to Chapter 7 proceedings in the U.S. are conducted under the *BIA*.

Significant amendments, to both the *BIA* and the *CCAA*, were brought into force on September 18, 2009. These amendments codify existing case law as well as implementing various technical and substantive reforms.

CORPORATE RESTRUCTURING STATUTES

In Canada, reorganizations can be conducted under the *BIA* or, for a company or income trust with at least $5 million in debt, under the *CCAA*.

Each act provides that creditors may be stayed from enforcing their claims. Canadian courts also have the power to coordinate local proceedings with any foreign insolvency proceedings involving the debtor.

PROPOSALS UNDER THE BANKRUPTCY AND INSOLVENCY ACT

The restructuring process begins by filing either a definitive proposal for compromising claims of creditors or a notice of intention to make a proposal. Once a notice or proposal is filed, all proceedings against the debtor are stayed automatically. Secured creditors are stayed from enforcing their security unless they gave a notice of intention to enforce security more than ten days before the debtor's notice or proposal was filed. Unless an extension is granted, the debtor must file a definitive proposal within 30 days of filing the notice of intention to make a proposal. A debtor who fails to do so is automatically deemed bankrupt.

The proposal under the *BIA* may be put to all creditors together, or to unsecured and secured creditors arranged in classes. If included, secured creditors with a "commonality of interest" must be in the same class. Although the proposal need not include all secured creditors, those excluded from the debtor's proposal are not bound by it and may enforce their security during the restructuring process.

The proposal must be accepted by a double majority of the creditors (one-half in number and two-thirds in value) and approved by the court. Once approved, it immediately binds all classes of unsecured creditors with provable claims that arose before the proposal's filing date as well as those included secured creditors in classes which vote in favour of the proposal. If the proposal is rejected by the creditors or the court, the debtor is automatically deemed bankrupt.

COMPANIES' CREDITORS ARRANGEMENT ACT

Subject to certain exceptions, protection under the *CCAA* is available to an insolvent Canadian corporation which has assets or carries on business in Canada if total claims against it exceed CDN$5 million. Affiliated companies' debts may be included to meet the threshold.

To initiate proceedings under the *CCAA*, the debtor files an application with the court. The application requests an order permitting the debtor to file a proposal for reorganization and granting a stay of proceedings. The initial stay cannot exceed 30 days. The *CCAA* provides the court with broad discretion concerning the scope of the stay. To date, the *CCAA*'s stay provision has been broadly interpreted, and it remains to be seen how the amendments will affect practice going forward. Certain amendments, such as suppliers rights and the treatment of executory contracts, discussed below, will impact the content of the initial stay order. If the court grants a stay, it will appoint a monitor to supervise the debtor's business and financial affairs.

Like the *BIA*, the *CCAA* allows creditors to be separated into different classes. The creditors must meet and vote on the debtor's proposed plan of reorganization, which must be accepted by the same double majority of creditors that the *BIA* requires.

Although restructuring under the *CCAA* is usually more expensive and time-consuming than under the *BIA*, larger corporate debtors tend to use the *CCAA* because there is greater flexibility to deal with complex reorganizations.

DEBTOR-IN-POSSESSION FINANCING

Courts have express authority under both the *BIA* and the *CCAA* to approve debtor-in-possession financing ("DIP"), subject to statutory guidelines. While DIP financing had been available prior to the amendments through the development of case law, the codification may make it easier to obtain priming DIPs.

BANKRUPTCY

Bankruptcy proceedings under the *BIA* are analogous to Chapter 7 proceedings. Debtors become bankrupt in Canada in one of the following three ways:

- by filing a proposal for reorganization that is either refused by the creditors, or accepted by the creditors and rejected by the court (as discussed above);
- by making an assignment for the general benefit of the creditors (voluntary bankruptcy); or
- by being petitioned into bankruptcy by one or more creditors (involuntary bankruptcy).

VOLUNTARY BANKRUPTCY

Debtors can make an assignment in bankruptcy only if they are "insolvent." Under the *BIA*, debtors are insolvent if:

- they cannot meet their obligations as they generally become due;
- they have stopped paying their current obligations in the ordinary course of business as they generally become due; or
- the value of their property is insufficient to satisfy their debts.

INVOLUNTARY BANKRUPTCY

A creditor can apply for a bankruptcy order in respect of a debtor who owes at least $1000 and has committed an "act of bankruptcy," as defined in the *BIA*, within the six months preceding the application. Most commonly, the application is filed because the debtor has ceased to meet its liabilities generally as they become due. Should the debtor dispute the application, the matter is referred to a judge for a hearing. Where the facts alleged in the application have been proven, the court will enter a bankruptcy order, declaring the debtor bankrupt.

An under-secured creditor may apply for a bankruptcy order for strategic reasons. For example, priorities between a secured creditor and some statutory claimants (as discussed above) may be "reversed" in certain circumstances if the debtor becomes bankrupt.

EFFECT OF BANKRUPTCY

A bankruptcy stays the claims of all creditors, except secured creditors. A trustee-in-bankruptcy is appointed and all of the debtor's assets vest in the trustee. The assets are sold and the proceeds are distributed among the debtor's creditors, in accordance with priorities determined by the *BIA*. Secured creditors, however, are generally not affected by these proceedings and are entitled to exercise their rights over the collateral for which they have a security interest.

INVESTIGATIONS AND REVIEWABLE TRANSACTIONS

Bankruptcy proceedings are sometimes also used by a creditor when the creditor wishes to investigate a debtor's affairs. The trustee has a statutory right to obtain possession of the bankrupt's books and records, to examine under oath the officers of the bankrupt or any other person reasonably thought to have knowledge of the bankrupt's affairs, and to require such a person to produce any documents in his or her possession or power relating to the bankrupt, the bankrupt's dealings or property. These powers may be important if there are concerns that the debtor has attempted to conceal certain assets or to conceal the transfer of certain assets.

Finally, bankruptcy proceedings can also be invoked to allow the trustee to attempt to reverse certain transactions entered into within prescribed periods prior to the bankruptcy, such a preferential payment or transaction entered into in order to defeat the claims of creditors.

REPOSSESSION OF GOODS BY SUPPLIERS

A lender who finances goods that a supplier provides to a debtor may be at risk if the debtor becomes bankrupt or insolvent within 30 days of receiving those goods. Under the *BIA*, unpaid suppliers may repossess goods delivered within 30 days before a bankruptcy or receivership if they make a demand for repossession within 15 days of the date of bankruptcy or receivership. However, among other things, if the purchaser altered or resold the goods, or the goods cannot be identified, the rule does not apply.

WAGE EARNER PROTECTION

Under the *Wage Earner Protection Program Act*, S.C. 2005, c. 47, s. 1 (the "*WEPPA*"), an employee whose employer has become bankrupt or subject to receivership on or after July 7, 2008 is entitled to receive payments from a federal Wage Earner Protection Program on account of any outstanding wages that were earned in the six months immediately prior to bankruptcy or the first day of receivership in an amount not to exceed the greater of $3,000 and four times the maximum weekly insurable earnings under the *Employment Insurance Act*, S.C. 1996, c. 23.

Corresponding amendments to the *BIA* are now in force that provide an employee of an employer which is bankrupt or in receivership, with a priority charge on the employer's "current assets" for unpaid 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 expenses for "traveling salespersons"). The priority charge ranks ahead of all other claims, including secured claims, except unpaid supplier rights.

PENSION PLAN CONTRIBUTIONS LIEN

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

The pension charge secures (1) amounts deducted as pension contributions from employee wages but not contributed to the plan prior to a bankruptcy or receivership and (2) amounts required to be contributed by the employer to a pension plan, for "normal costs". The priority does not extend to unfunded deficits arising upon a wind-up of a defined benefit plan and should not include scheduled catch-up or special payments required to be made by an employer because of the existence of a solvency deficiency.

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

OTHER NOTABLE AMENDMENTS TO CANADA'S INSOLVENCY LEGISLATION

In addition to the wage and pension legislation discussed above, further amendments that came into force on September 18, 2009 include:

- changes to the cross-border insolvency rules, including the adoption of some elements of the UNCITRAL model law, which also formed the basis for Chapter 15 of the recently amended *US Bankruptcy Code*;
- authorization to assign or disclaim executory contracts, excluding collective bargaining agreements, financing agreements where the debtor company is the borrower, real property leases where the debtor is the lessor as well as derivative and other "eligible financial contracts"; and
- debtors are expressly authorized to pursue asset sales out of the ordinary course of business during a restructuring, including a going-concern sale of a business.

  The sale must be approved by the court, which is to consider a number of specific criteria, and notice of a sale must be given to secured creditors who are likely to be affected by the sale.

For a more detailed discussion of Canadian insolvency legislation and the amendments, please refer to McMillan's publications available at <www.mcmillan.ca>.

A CAUTIONARY NOTE

The foregoing provides a summary of aspects of Canadian law that may interest investors considering doing business in Canada. A group of McMillan lawyers prepared this information, which is accurate at the time of writing. Readers are cautioned against making decisions based on this material alone. Rather, any proposal to do business in Canada should most definitely be discussed with qualified professional advisers.

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• COURT OF APPEAL AFFIRMS LIMITATION PERIOD ON DEMAND OBLIGATIONS •

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In our article entitled *Limitation Periods: Co-Extensive for Guarantees; New Period for Demand Obligations*,[1] we summarized the decision of the Ontario Superior Court of Justice in *The Bank of Nova Scotia v. Anthony R. Williamson* (the "*Williamson Judgement*"),[2] in which the Court agreed with the Bank in holding that the limitation period for the principal debt and for the guarantee may commence at different times and that there is no requirement that demand must be made upon the guarantor and the principal debtor at the same time.

Williamson appealed the decision to the Ontario Court of Appeal, which considered whether a demand guarantee requires a demand before it is enforceable and the impact of the *Limitations Act*, *2002*,[3] amendments in respect of the commencement of the limitation period for demand obligations.

In *The Bank of Nova Scotia v. Williamson* (the "*Williamson Appeal*"),[4] the Court of Appeal held that where the obligation of a third party guarantor is to pay on demand, as was the case, the demand is a condition precedent to the obligation to pay. It follows that the time for commencing an action on a demand guarantee does not begin to run until a demand has been made.

Collateral obligations which include an obligation to pay on demand, such as guarantees or collateral mortgages given by third parties to secure the debt obligation of a primary debtor, require a demand before they are enforceable.

In respect of the November 28, 2008 amendments to the *Limitations Act*, *2002*, which provide that the limitation period with respect to a demand obligation starts to run on the first day on which there is a failure to perform the obligation, once a demand for performance is made, the Court of Appeal confirmed that it was the intent of the legislature that for all demand obligations a demand is a condition precedent to the commencement of the limitation period.

In so doing, the Court of Appeal has affirmed that the *Limitations Act, 2002* amendments have the effect of overturning its controversial decision in *Hare v. Hare*,[5] in which it was held that the *Limitations Act, 2002* did not, nor was intended to change the common law position that a debt is owed as soon as the monies are advanced.

Consistent with the decision in the *Williamson Judgment*, the decision in the *Williamson Appeal* is favourable to lenders in that it solidifies the view that the limitation period on a guarantee does not commence until demand has been made on the guarantee, and affirms our reading of the *Limitations Act*, *2002* amendments such that lenders, among others, will have two years from the date of the demand to commence a claim for recovery.

In respect of guarantees, we continue to advise that demand phrasing should be explicitly included in guarantees, as should enforceability phrasing indicating that the guaranteed obligation is payable or enforceable at a certain time period after demand is made. It would also be prudent to add a provision regarding the *Limitations Act*, *2002* indicating that the basic period of two years does not apply, which is permitted under the *Limitations Act*, *2002* in that one can contract out of a limitation period in respect of "business agreements".

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1 28 Nat. B.L. Rev., August 2009.
2 [2008] O.J. No. 4756.
3 S.O. 2002, c. 24, Schedule B.
4 [2009] O.J. No. 4507, 2009 ONCA 754.
5 [2006] O.J. No. 4955, 83 O.R. (3d) 766.

• PASSING AND ASSENT OF BILL 74, *AN ACT TO AMEND VARIOUS LEGISLATIVE PROVISIONS PRINCIPALLY TO TIGHTEN THE REGULATION OF THE FINANCIAL SECTOR* •

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Bill 74, *An Act to amend various legislative provisions principally to tighten the regulation of the financial sector*[1] (the "*Act*"), which was tabled on November 12, 2009 by Québec's Minister of Finance, Raymond Bachand, was passed by the National Assembly of Québec on December 3, 2009 and received assent on December 4, 2009. This new legislation amends several laws affecting the financial sector and, according to the Minister, seeks to respond to numerous concerns raised in the wake of the global financial crisis and recent financial scandals. This article summarises the principal amendments proposed in the *Act*.

CONSECUTIVE PRISON TERMS

In light of recent financial scandals and the courts' re-examination of the prison terms imposed for offences under financial laws, the Québec government deemed it appropriate to introduce the principle of consecutive sentencing in Québec. The *Act* therefore proposes to amend Article 241 of the *Code of Penal Procedure*[2] in order to specify that an offender found guilty of several offences can be condemned to serve consecutive prison terms.[3] This amendment complements and supports the October 20, 2009 motion filed by the Autorité des marchés financiers ("AMF") petitioning the Supreme Court of Canada to hear its appeal of the Court of Appeal of Québec's decision in a penal procedure that the AMF instituted in the Norbourg scandal. Since the Supreme Court of Canada refuses the hearing of the appeal at the beginning of 2010, Québec legislators thus hope to fill the legal void surrounding consecutive prison terms that has existed since that Court of Appeal of Québec decision.

OVERSIGHT OF CREDIT RATING ORGANIZATIONS

In response to the aftermath of the global financial crisis, the Québec government wants to become the first Canadian province to oversee credit rating organizations, which assign credit ratings reflecting their evaluation of securities issuers' ability to meet financial obligations. The *Act* therefore introduces a new legislative framework for credit rating organizations in the Québec *Securities Act* ("*SA*").[4] The *SA* is thus amended by the addition of the new ss. 186.1 to 186.6, which confer upon the AMF the power to designate a credit rating organization as being subject to this new regime, and give it broad regulatory powers over credit rating organizations on such matters as governing the conduct of the directors, officers and employees of these organizations, prohibiting such organizations from issuing or maintaining a credit rating, and managing conflicts of interest.[5] The AMF may not, however, regulate the content of a credit rating or the methodology used by a designated credit rating organization.

AMENDMENTS TO THE QUÉBEC DEPOSIT INSURANCE PLAN

In order to grant the AMF the same powers as the Canada Deposit Insurance Corporation (the "CDIC") to intervene with deposit-taking institutions registered in Québec's money deposit protection plan and that are facing solvency issues, the *Deposit Insurance Act* (the "*DIA*")[6] is amended by the *Act* as follows:

- S. 1 is amended to specifically state that the purpose of the *DIA* is to foster the stability of the financial system in Québec by establishing a plan to protect deposits of money in the event of the actual or apprehended insolvency of a registered institution, and a new s. 1.1 is introduced to replace the repealed ss. 25 and 26 of the *DIA*, and provides that the *DIA* applies to all deposits of money made in Québec, with the exception of the following, which are not considered to be deposits to which the *DIA* applies:
    - o deposits that are not payable in Canada or in Canadian currency;

  - deposits made with banks that are not member institutions of the CDIC;
  - deposits whose term exceeds that prescribed by the regulations adopted under the *DIA*;
  - funds obtained at the time of an issue of securities;
  - sums payable under an insurance or annuity contract; and
  - a promissory note payable in one year or less and, if distributed to a natural person, evidencing a debt of $50,000 or more.[7]

- The new ss. 34.4 and 35.1 are added to allow the AMF to grant a depositor interest on the deposit of money from a registered institution that is being liquidated or wound-up.[8]
- The new Sections 40.0.1 through 40.0.9 are introduced to confer upon the AMF the power to provide guidelines to registered institutions concerning the advertising of, and information supplied about, the guarantee covering money deposit products, and allowing the AMF to establish and enforce sound commercial practices to be followed by registered institutions.[9]
- A new s. 41.3 is added, allowing the AMF to audit or commission an audit of any book, register, or other document of a registered institution if, in the AMF's opinion, the execution of its obligation under a guarantee seems unavoidable.[10]
- The new subs. (f) and (g) are added to s. 40 to allow the AMF to:
  - constitute a legal person responsible for carrying out the winding-up of the assets acquired from a registered institution;
  - acquire any security issued by a registered institution; and
  - apply to the Superior Court for an order to force the sale or amalgamation of a registered institution whose permit has been suspended or cancelled;[11]
- The Section 40.3.1 is replaced to allow for the automatic reduction of a premium paid by financial services cooperatives that are members of a security fund[12] in consideration for the fact that this security fund will henceforth act as the first line of defence should a government intervention become necessary.[13]
- The $700,000,000 limit applicable to commitments undertaken by the AMF which can be guaranteed by the government of Québec under s. 55 of the *DIA* is repealed.[14]

TIGHTER REGULATION OF FOREIGN INSURERS

Insurers currently doing business in Québec that are not incorporated under Québec law are not subject to the rules governing maintenance of adequate liquid assets with which Québec insurers must comply under the *Act respecting insurance* (the "*ARI*").[15] A new paragraph is therefore added to s. 243 of the *ARI* subjecting insurers constituted under an act of a jurisdiction other than Québec to s. 269 of the *ARI* relating to the maintenance of a capital base and to ss. 275, 275.0.1, 275.3 and 275.3.1 of the *ARI*, relating to adequate assets.[16] Section 269 of the *ARI* is greatly simplified in order to state only that every insurer must maintain adequate assets permitting the insurer to guarantee the execution of its obligations in Québec.[17] A new Section 285.37 is added to the *ARI* specifying that an insurer that transacts exclusively in reinsurance is not subject to ss. 285.30 through 285.36 of the *ARI*, which deal with the complaint examination procedure and dispute resolution between insurers and insured persons that declare themselves dissatisfied with the examination of a complaint.[18] Finally, s. 325.0.2 of the *ARI* is amended to confer upon the AMF the power to issue guidelines regarding the maintenance of adequate assets and capital for insurers.[19]

STIFFER PENALTIES FOR OFFENCES

In order to ensure better compliance with financial sector regulations, the government wishes to impose stiffer penalties and harmonize the offence system under the *Act respecting the distribution of financial* *products and services* (the "*ARDFPS*")[20] with that of the *Derivatives Act* (the "*DA*")[21] as follows:

- S. 115 of the *ARDFPS* is amended to confer upon the Bureau de décision et de revision the power to impose a penalty not exceeding $2,000,000 on an non-compliant firm;[22]
- S. 376 of the *ARDFPS* is amended to confer upon the discipline committee the power to impose a fine of not less than $2,000 nor more than $50,000 for each offence;[23] and
- Ss. 485 to 490 of the *ARDFPS* are replaced in order to increase the maximum administrative penalties;[24]

Sections 273.1 of the *SA* and 134 of the *DA* are also amended to increase the maximum penalty to $2,000,000.[25]

MOTOR VEHICLE REPLACEMENT GUARANTEES AND DISTRIBUTION OTHERWISE THAN THROUGH A REPRESENTATIVE

On March 27, 2009, the AMF published a notice stating that it now considers motor vehicle replacement guarantees to be an insurance product subject to AMF oversight in Québec. The AMF had given itself a 12-month period to work with the various parties involved to determine how this property and casualty insurance product should be distributed. A consensus seems to have been reached by the AMF so that insurers offering these replacement insurance products may now distribute them through such distributors as car dealers, who will give their clients a distribution guide prepared by the insurer offering the product in accordance with the rules set out in the *ARDFPS*. This Act is therefore amended by the insertion of the new s. 408.1, which provides that the only insurance products relating to a vehicle or an immovable sold by a distributor that may be offered by the distributor are those described in s. 424 of the *ARDFPS*.[26] Furthermore, it is specified that an automobile within the meaning of the *Automobile Insurance Act*[27] and a vehicle to which the *Act respecting off-highway vehicles*[28] applies are considered to be vehicles under the *ARDFPS*. A fifth paragraph is inserted in s. 424 stating that replacement insurance is an insurance product that can be distributed with a distribution guide.[29]

The following amendments are introduced to the *ARDFPS* in order to better lay the ground for distributing insurance products otherwise than through a representative.

- Ss. 414 and 419 are amended to simplify the process of forwarding a copy of the distribution guide to the AMF;[30]
- S. 423 is replaced to add new regulatory powers for AMF regarding distributions guides;[31]
- The second paragraph of s. 426 of the *ARDFPS* is amended in order to provide that investors' health and employment insurance are also deemed to be insurance products which relate solely to goods and to which clients adhere and can therefore be distributed otherwise than through a representative;[32]
- S. 434, which requires distributors to inform the client of the procedure for making a claim and of the time available to the insurer to pay the insured amounts is repealed;[33]
- S. 436 is amended in order that the insurer now be liable if the distributor's non-compliance results from the insurer's failure to comply with a provision of the *ARDFPS* or with or a regulation regarding distribution without a representative;[34]
- S. 466.1 is added in order to provide that every person that pays a commission in connection with the sale of a financial product or the provision of a financial service to an individual who is not authorised to share a commission with another firm, independent representative or independent partnership under the *ARDFPS* is guilty of an offence;[35]
- S. 468 is expanded to better specify the offences resulting from obstructing an AMF representative's work in the context of an investigation or inspection.[36]

BUREAU DE DÉCISIONS ET DE RÉVISION

The provisions of the *Act respecting the Autorité des marchés financiers*[37] are amended in order to broaden the powers of the Bureau de décision et de révision en valeurs mobilières to include distribution of financial products and services governed by the

ARAMF. The Bureau is now called the "Bureau de décision et de révision".[38]

DERIVATIVE INSTRUMENTS

Certain provisions of the Act respecting the Autorité des marchés financiers, the Act respecting International financial centres,[39] the Real Estate Brokerage Act,[40] the ARDFPS, the Taxation Act,[41] the Act respecting labour standards,[42] and the Notarial Act[43] are amended for reasons of harmonization with the new DA.[44] Certain provisions of the DA also received technical amendments and were harmonised with other legislation.[45]

Many financial institutions and financial product distributors will be affected by the provisions of the *Act* after they came into force. Financial sector participants should therefore prepare to re-examine their activities in order to comply quickly with these new requirements, many of which have been in force since December 4, 2009, and others are expected to come into force later in 2010.

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1 S.Q., 2009, c. 58
2 R.S.Q., c. C-25.1.
3 *Supra* note 1, s. 43.
4 R.S.Q. c. V-1.1.
5 *Supra* note 1, s. 100.
6 R.S.Q. c. A-26.
7 *Supra* note 1, s. 3.
8 *Ibid*. ss. 13 and 15.
9 *Ibid*. s. 17.
10 *Ibid*. s. 21.
11 *Ibid*. s. 16.
12 *Ibid*. s. 19.
13 *Ibid*. s. 11, para. 3.
14 *Ibid*. s. 26.
15 R.S.Q. c. A-32.
16 *Supra* note 1, s. 28.
17 *Ibid*. s. 29.
18 *Ibid*. s. 30.
19 *Ibid*. s. 31.
20 R.S.Q., c.D-9.2.
21 R.S.Q., c. I-14.01.
22 *Supra* note 1, s. 57.
23 *Ibid*. s. 65.
24 *Ibid*. s. 84.
25 *Ibid*. ss. 120 and 169.
26 *Ibid*. s. 69.
27 R.S.Q., c.A-25.
28 R.S.Q., c.V-1.2.
29 *Supra* note 1, s. 73.
30 *Ibid*. ss. 70 and 71.
31 *Ibid*. s. 72.
32 *Ibid*. s. 74.
33 *Ibid*. s. 75.
34 *Ibid*. s. 76.
35 *Ibid*. s. 79.
36 *Ibid*. s. 80.
37 R.S.Q., c.A-33.2.
38 *Supra* note 1, ss. 1 and 32 to 44.
39 R.S.Q., c.C-8.3.
40 R.S.Q., c C-73.1 and S.Q. 2008, c.9.
41 R.S.Q., c.I-3.
42 R.S.Q., c.N-1.1.
43 R.S.Q., c.N-3.
44 *Supra* note 1 ss. 32, 33, 43, 44, 46 to 51, 87 to 90 and 139.
45 *Supra* note 1 ss. 154 to 178.

• STRICT COMPLIANCE WITH LETTER OF CREDIT NOT ALWAYS ENOUGH — FAIRNESS AND EQUITY IN LETTER OF CREDIT TRANSACTIONS •

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Borden Ladner Gervais LLP

CASE COMMENTARY:
NAREERUX IMPORT CO. LTD. v. CANADIAN IMPERIAL BANK OF COMMERCE

In the recent decision of *Nareerux Import Co. Ltd. v. Canadian Imperial Bank of Commerce,* 97 O.R. (3d) 481, the Ontario Court of Appeal considered principles of fairness and equity in letter of credit transactions. The Court recognised an implied contractual duty of good faith not to act in a way that defeats the purpose and objective of a letter of credit.

The case concerned letters of credit issued by CIBC in favour of Thai Fisheries Co. Ltd. to ensure payment by Douglas R. Robertson International Inc. ("Robertson") for approximately $40 million worth of shrimp. Robertson intended to sell the shrimp to Sam's Club.

Robertson financed the shrimp purchase through a credit facility arranged with CIBC. The possibility of a delay between Robertson's obligation to pay Thai Fisheries under the Letters of Credit and Robertson's shrimp sale to Sam's Club caused CIBC concern over its risk exposure in the credit facility. CIBC sought to address its concern by incorporating a "Special Condition" into the Letters of Credit that would delay payment to Thai Fisheries until Robertson presented to CIBC receipts for its shrimp sale to Sam's Club.

The Special Condition created an atypical arrangement. Whereas under a conventional letter of credit a seller controls the satisfaction of the conditions necessary for payment, the Special Condition transferred such control to the purchaser. If Sam's Club did not purchase shrimp from Robertson, the prerequisite for payment under the Letters of Credit would not be met. Additionally, by delaying presentation of Sam's Club receipts, Robertson could control the flow of money to Thai Fisheries.

The relationship between Robertson and Thai Fisheries deteriorated. Robertson did not present receipts for Sam's Club shrimp purchases and, as a result, Thai Fisheries did not receive payment for over $6 million of shrimp. Meanwhile, Robertson used the proceeds from the sales to pay down its line of credit with CIBC. CIBC knew this was happening; further, CIBC permitted Robertson to sell approximately $4 million of shrimp to other purchasers, ensuring that Thai Fisheries would never receive payment for those shrimp.

Upon receiving notice from CIBC that the Letters of Credit had expired, Thai Fisheries sued for the unpaid monies.

The trial judge ruled in favour of Thai Fisheries, awarding it the full amount of money owed to it under the Letters of Credit. There were three grounds of liability. One, CIBC participated in Robertson's sales to buyers other than Sam's Club, which prevented Sam's Club from issuing the receipts necessary for Thai Fisheries to receive payment; two, CIBC breached fiduciary obligations to notify Thai Fisheries that Robertson was selling to buyers other than Sam's Club and choosing to act as a lender seeking satisfaction of what it is owed; and three, this conduct constituted a breach of an implied duty to Thai Fisheries to act in good faith.

In its appeal, CIBC relied on the defence of strict compliance, arguing that it had strictly complied with the terms of the Letters of Credit. The presentation of receipts from Sam's Club was a precondition to payment; as no receipts were presented by Robertson, CIBC was not liable to pay the proceeds of the shrimp sale to Thai Fisheries. Moreover, it was the responsibility of Thai Fisheries, a commercially sophisticated party, to inspect the terms of the credit before accepting it. Once Thai Fisheries accepted the Special Condition, CIBC was required to strictly comply with it.

In upholding the trial judge's decision, the Court held that CIBC was disentitled to rely on the defence of strict compliance. Because CIBC knowingly contributed to the circumstances that frustrated the Special Condition, and then used that non-compliance to justify the refusal of payment to Thai Fisheries — all while applying the proceeds from the shrimp sales to reduce Robertson's overdraft — CIBC had directly breached the contractual obligations it had to Thai Fisheries.

More significantly, the Court held that CIBC had also indirectly breached its contract with Thai Fisheries by breaching an implied contractual duty of good faith. While the law does not recognise a stand-alone duty of good faith in the performance of a contract, "the jurisprudence establishes that there is an implied contractual duty of good faith not to act in a way that defeats or eviscerates the very purpose and objective of the agreement". The Court held that the trial judge was correct in holding that the Letters of Credit "were infused with an implied duty of good faith of that nature".

The Letters of Credit allowed CIBC to exert a discretionary control over documentary compliance and timing of payments. Contracts in which performance depends on the exercise of discretion contain an implied duty of good faith performance. By participating in a ploy with Robertson to frustrate compliance with the Special Condition, CIBC exercised its discretion in its own self-interest to the effect of rendering the Letters of Credit commercially meaningless. This was a breach of the implied term of good faith. The Court agreed that in the circumstances, the trial judge was justified in rejecting CIBC's attempts to rely upon the doctrine of strict compliance.

Although *Nareerux Import Co. Ltd. v. Canadian Imperial Bank of Commerce* does not import a broad duty of good faith into the law of letters of credit, it should nonetheless be considered when issuing letters of credit. Certainty and strict compliance are essential elements to the proper functioning of documentary letters of credit. This case illustrates the dangers posed by discretionary terms in letters of credit, where certainty is required. Where the terms of a letter of credit provide a party with discretionary control over some aspect of compliance, that control must be exercised in good faith and good faith performance may trump the doctrine of strict compliance.

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