Cross-Border Securitization Transactions between Canada and the U.S.

Key Legal Considerations

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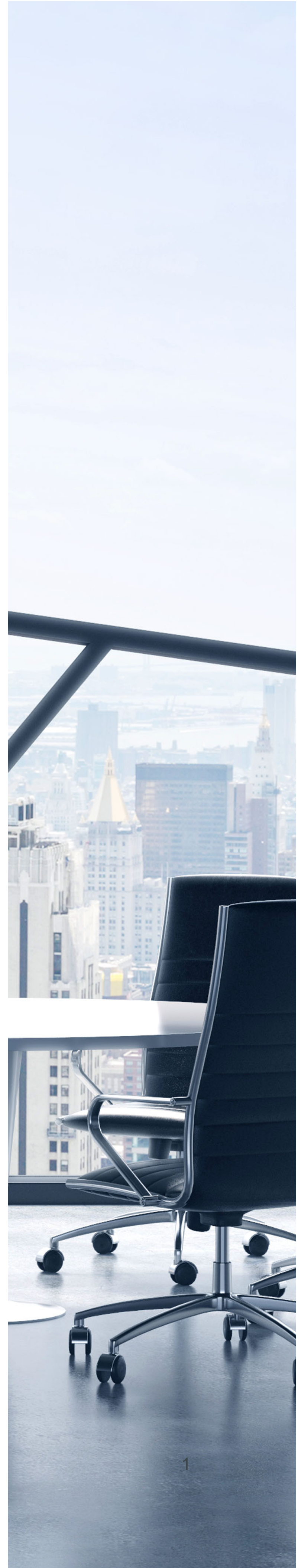
Introduction

The Structured Finance Group at McCarthy Tétrault LLP is pleased to present ***Cross-Border Securitization Transactions between Canada and the U.S. – Key Legal Considerations.***

In recent years, there has been a significant increase in the volume of cross-border securitization transactions between Canada and the U.S., with market participants now regularly pursuing cross-border securitization transactions in a wide range of contexts. A Canadian originator may choose to sell receivables to a U.S. special purpose vehicle (“**SPV**”) as part of a global trade receivables securitization program, for example, or a Canadian issuer may choose to offer asset-backed securities to U.S. investors as a complement to an offering in Canada.

Although the variety of cross-border securitization transactions is practically unlimited, there are a number of legal considerations that are common throughout these different transactions. This article highlights some of the main principles of Canadian law that U.S. legal practitioners should bear in mind when working on cross-border securitization transactions between Canada and the U.S. This article is not intended to be exhaustive of all relevant legal considerations, and U.S. legal practitioners are encouraged to seek assistance from qualified Canadian counsel when engaging in such transactions.



Licensing Considerations

In all cross-border securitization transactions, it is critical to consider whether any relevant U.S. entities are subject to licensing requirements in Canada. This is particularly true where the relevant U.S. entities are foreign banks (or foreign bank affiliates). Under the *Bank Act* (Canada) (the "**Bank Act**"), foreign bank entities are generally prohibited from conducting banking activities in Canada, unless they are licensed to carry out such activities, or their activities do not rise to the level of "carrying on business in Canada".

Unfortunately, the Bank Act does not include a definition of the phrase "carrying on business in Canada", but the Office of Superintendent of Financial Institutions ("**OSFI**"), which is the regulator of foreign and domestic banks in Canada, has provided some guidance on the meaning of this phrase. OSFI has indicated that whether a particular activity constitutes "carrying on business in Canada" requires a contextual analysis of the facts. A single fact or consideration may not be dispositive of the issue. OSFI has noted that the following facts are relevant in conducting this analysis: (i) whether the foreign bank has an office or employees in Canada; (ii) whether the foreign bank makes trips to Canada for purposes of underwriting existing or potential credit risk; (iii) whether the foreign bank forms contracts and carries out negotiations in Canada; and (iv) whether the foreign bank realizes on security in Canada.

Generally speaking, as long as a foreign bank follows a code of conduct that requires it to conduct its banking activities outside of Canada, then those activities will not rise to the level of "carrying on business in Canada". This is commonly referred to as "suitcase banking". The essence of the code of conduct is limiting, to the greatest extent possible, a foreign bank's physical presence in Canada. In our experience, foreign banks that are involved in cross-border securitization transactions are often able to structure their activities in a manner that does not rise to the level of "carrying on business in Canada", and thus they are generally not exposed to any licensing requirements under the Bank Act.

In addition to banking, other types of business activities carried on by U.S. entities in Canada may be subject to licensing requirements under specific federal or provincial legislation. For example, residential mortgage servicing and collection activities are regulated under consumer protection legislation in effect in certain of the provinces of Canada.

It is important to consider whether any special licensing requirements exist in the early stages of planning a cross-border securitization transaction, as these licensing requirements can have a significant impact on the transaction structure and timeline.

Tax Considerations

Income Taxes

Under the *Income Tax Act* (Canada) (the "**Tax Act**"), a U.S. entity is generally liable to pay taxes on any income earned in Canada, if that U.S. entity is "carrying on business in Canada". Similar to the Bank Act, the Tax Act does not include a definition for the phrase "carrying on business in Canada", and accordingly, the meaning of this phrase is derived from case law, as well as guidance from the Canada Revenue Agency (the "**CRA**"), which is Canada's tax regulator.

Based on the relevant authorities, a cross-border purchase and sale of receivables or asset-backed securities between a Canadian entity and a U.S. entity would generally not, in and of itself, constitute carrying on business in Canada that would trigger Canadian income tax liability for a U.S. entity. However, if a U.S. entity's business activities in Canada extend beyond a mere purchase and sale of receivables or asset-backed securities (e.g., servicing and collection of receivables), then it may be subject to Canadian income tax.

In order to avoid the potential for Canadian income tax, a U.S. entity should be careful to conduct its business and affairs in a manner that minimizes touchpoints with Canada, consistent with the code of conduct described above.

Withholding Taxes

In 2008, the federal government of Canada eliminated withholding tax on most cross-border payments of interest from a Canadian entity to a U.S. entity. As a result, payments of interest on receivables sold by a Canadian originator to a U.S. SPV are generally not subject to withholding taxes. Similarly, payments of interest on asset-backed securities sold by a Canadian entity to a U.S. entity are generally not subject to withholding taxes.

The Tax Act includes certain exceptions to this rule that may result in withholding taxes being levied on interest payments, including where the payor and the payee are not dealing with each other at arm's length (i.e., the payor and the payee are affiliated with one another), or where the interest is "participating debt interest" (i.e., interest that is contingent or dependent on the use of or production from property in Canada, or that is computed by reference to, among other things, revenues, profits, cash flows or commodity prices).

In addition, it is important to note that withholding tax may apply to certain cross-border payments other than interest payments, including rent or lease payments, royalties and dividends.

Sales Taxes

Typically, an assignment of receivables by an originator to an SPV will not attract any sales taxes, as a sale of receivables is exempt from the goods and services tax ("**GST**") imposed by the federal government of Canada, as well as the provincial sales tax ("**PST**") imposed by the provincial governments of certain provinces (which in some provinces, has been harmonized with the GST to form a single harmonized sales tax ("**HST**")).

However, in securitization transactions that involve an assignment of tangible property (such as leased cars and equipment) together with the related receivables, the assignment of the tangible property may be subject to sales taxes.

Similarly, in securitization transactions that contemplate payment of servicing fees, these servicing fees may be subject to sales taxes. In order to avoid sales taxes on servicing fees, most transfers of receivables by an originator to an SPV are done on a "fully serviced basis" for a single consideration, which means that the originator, which is typically also the initial servicer, is not paid a separate servicing fee in exchange for servicing the receivables on behalf of the SPV.

Personal Property Security Considerations

Personal Property Security Act Considerations

All securitization transactions involve an assignment of receivables. This raises important personal property security considerations, because under the *Personal Property Security Act* (the "**PPSA**") that exists in each province and territory of Canada other than the Province of Québec (which is addressed below), an assignment of receivables by one party to another is deemed to create a security interest that must be perfected, in order to be effective against third parties.

An assignee will typically perfect the security interest resulting from an assignment of receivables by registering a financing statement in the PPSA registry in the province or territory where the assignor of the receivables is "located" for purposes of the PPSA. Unfortunately, the PPSAs across the different provinces and territories of Canada do not include uniform rules about where an assignor of receivables is located, which often necessitates registrations in multiple jurisdictions.

In addition to perfecting the security interest associated with an assignment, a secured party is also required to perfect a conventional security interest in personal property, such as a security interest under a general security agreement. Depending on the form of personal property that is subject to a security interest, there may be other methods of perfection available beyond registration, including perfection by possession or control.

Significantly, in certain provinces of Canada including the Province of Ontario, it is now possible to perfect a security interest in electronic chattel paper by way of control, which has helped to facilitate securitization of receivables in the auto and equipment finance spaces.

The Civil Code of Québec Considerations

The *Civil Code of Québec* (the "**CCQ**") governs the assignment of "claims" (i.e., receivables) and the granting of "hypothecs" (i.e., security interests) in personal property in the Province of Québec. Similar to the PPSA jurisdictions, the CCQ provides that an absolute assignment of claims must be "set-up" or "rendered opposable" (i.e., perfected) in order to be effective against third parties.

In Québec, it is possible to render an absolute assignment of claims effective against third parties by means of a registration in the Register of Personal and Movable Real Rights (the "**RPMRR**"), if the assignment constitutes a "universality of claims, present or future". The CCQ does not provide a definition for the concept of a "universality of claims", and accordingly, there is some uncertainty as to the meaning of this phrase. The general market view is that an assignment of all the receivables originated by an originator, or an assignment of all of the receivables originated by an originator between two specified dates (in some cases, excluding a specified list of receivables), would constitute a universality of claims.

If the description of the receivables being sold under a particular absolute assignment does not constitute a universality of claims, then the assignment of such receivables may be made effective both against the obligors, as well as any third parties, by the assignor providing a notice of the assignment to the obligors that meets certain requirements set forth in the CCQ.

Interest Rate Considerations

At least two points relating to interest rates need to be considered when structuring Canadian securitization transactions. First, under the *Interest Act* (Canada), most legal agreements that contemplate the payment of interest must include an express statement of the annual interest rate. This is relevant for many legal agreements in the securitization space, as interest is often calculated on the basis of a 360-day year, rather than a 365-day year. In these agreements, it is common to include a provision that sets out a formula for converting the non-annual rate of interest into an annual rate of interest. The omission of this type of provision is significant, as the *Interest Act* (Canada) provides that a failure to state that the annual rate of interest means that a creditor is only entitled to charge interest at a rate of 5% per annum.

Second, under the *Criminal Code* (Canada), it is a criminal offence to charge “interest” at a rate exceeding 60% per annum. Interest is broadly defined under the *Criminal Code* (Canada) as the aggregate of all charges and expenses, whether in the form of fees, fines, penalties, commissions or other similar charges or expenses charged to the debtor. Because of the wide scope of the concept of interest, and the potential for inadvertently exceeding the maximum rate, many legal agreements in Canadian securitization transactions will include a provision stating that any contravention of the maximum rate is unintentional, and that all payments of interest in excess of the maximum rate will be refunded to the debtor, or applied to other outstanding obligations of the debtor.

Currency Considerations

Historically, most Canadian securitization transactions have involved Canadian dollar assets and Canadian dollar liabilities. With the increase in the frequency of cross-border securitization transactions, however, market participants now regularly fund Canadian dollar assets with U.S. dollar liabilities, and vice versa. This fact pattern introduces currency risk into a securitization transaction, because if the currency of an SPV’s assets does not match the currency of its liabilities, then adverse movements in the currency exchange rate may result in the SPV not having sufficient assets to secure or repay its liabilities.

There are several ways to address this type of currency risk in a securitization transaction, including through the introduction of a currency hedge at the SPV level (i.e., the SPV swaps the cashflows on its assets into the currency of its liabilities, thus ensuring it has enough money to satisfy these liabilities), or currency reserves (i.e., the SPV sets aside cashflows in a reserve in order to protect the financing party from currency exchange losses).

Another currency-related consideration is that Canadian courts can also only issue judgements in Canadian dollars. Accordingly, if a U.S. party seeks a judgement in a Canadian court, it may be exposed to currency risk associated with the judgement being denominated in Canadian dollars. For this reason, Canadian securitization transaction agreements will often include a currency indemnity provision, where the Canadian originator covenants to indemnify the U.S. financing party for any currency losses sustained in connection with judgement being denominated in Canadian dollars.

Assignability Considerations

The PPSAs in each province and territory of Canada other than the Province of Québec provide that a contractual restriction on the assignment of a receivable is unenforceable against third parties, as long as the entirety of the receivable is transferred, and not merely an interest in the receivable. Accordingly, contractual restrictions on assignment will generally not render an assignment void; however, an assignment of a receivable in breach of a contractual restriction can expose the assignor to a breach of contract claim by the obligor.

While there is no similar “override” or “anti-assignment” provision in the Province of Québec, the CCQ does include a set of rules that are applicable to provisions that restrict the free disposition of certain property. As a result, there is a legal basis for the position that an assignment made in breach of an anti-assignment clause does not invalidate the assignment as between the assignor and the assignee, leading to the same outcome as in the other provinces and territories of Canada. There remains some uncertainty on this issue in the Province of Québec, however, given the absence of a specific provision similar to that found in the PPSA jurisdictions.

Although the anti-assignment provisions in the PPSAs are helpful in facilitating securitizations of most types of receivables, government receivables do present some challenges. Under the *Financial Administration Act* (Canada), an assignment of a receivable owing by the federal government of Canada and certain federal corporations is invalid unless: (i) the assignment is absolute; and (ii) notice of the assignment has been given in a prescribed form to the appropriate government representative. Several provinces of Canada have enacted legislation that includes similar limitations on the assignments of receivables owing by provincial governments and corporations. Because of these limitations, securitizations of government receivables are fairly uncommon.

True Sale Considerations

In Canada, as in the U.S., there is a risk that a court may re-characterize a securitization of receivables as a secured loan transaction rather than a sale transaction. In order to mitigate this risk, market participants must be careful to structure their securitization transactions in a manner that respects the principles of a “true sale”.

Unfortunately, there is very limited jurisprudence in Canada on what constitutes a “true sale”. In the *Telus*[1] case, which is the leading Canadian decision on the matter, the court suggested that the following factors are indicative of a sale rather than a secured loan: (i) the intention of the parties, (ii) the transfer of the risk of ownership, (iii) the assets sold are identifiable, (iv) the purchase price is determinable with certainty, (v) the right to retain surplus collections, (vi) the extent of any right of redemption, and (vii) the responsibility for collection of accounts.

Most of the factors articulated in the *Telus* case are consistent with the factors set forth in U.S. cases, and accordingly, Canadian securitization transactions resemble U.S. securitization transactions to a large degree. However, the first factor – the intention of the parties – does lead to one key difference between Canadian and U.S. securitization transactions. Specifically, to ensure that the intention of the parties is clear, Canadian securitization transactions typically do not include a “back-up security interest” provision in the transfer agreements, which stems from a concern that this provision could jeopardize the intended characterization of the transaction as a sale.

It is not necessary for a transaction to satisfy all of the factors set forth above in order to be characterized as a sale transaction, although the presence of a unilateral repurchase right in favour of the seller of the receivables is often considered to be determinative of a secured loan, rather than a sale.

[1] *Metropolitan Toronto Police Widows and Orphans Fund et al v Telus Communications Inc.* [2003] O.J. No. 128.

Securities Law Considerations

Disclosure and Filing Requirements

Many cross-border securitization transactions will involve an issuance of securities to investors in Canada, and accordingly, it is important for U.S. practitioners to be familiar with Canadian securities laws.

In Canada, like in the U.S., the issuance of securities to investors is subject to extensive disclosure and filing requirements. If securities are being issued in a public offering, then an issuer will need to prepare an offering document known as a "prospectus", which is similar to a registration statement in the U.S., and which will be subject to review by provincial securities regulators. The prospectus will need to comply with detailed form requirements, which may vary depending on the type of public offering that is being conducted.

Where securities are being issued in a private placement, there is generally no requirement for an issuer to prepare an offering document. In many cases, however, an issuer will choose to prepare an offering document known as an "offering memorandum" to assist with the marketing of the securities. Unlike a prospectus, there are generally no form requirements for an offering memorandum, although some provinces do require that an offering memorandum disclose certain statutory rights of action for damages or rescission.

If an issuer prepares an offering memorandum, then it will need to ensure that the offering memorandum does not contain a "misrepresentation", or the issuer may be liable to investors under both statutory and tort law. A "misrepresentation" is an untrue statement of a "material fact" or an omission to state a "material fact" that is required to be stated so that investors are not misled. A "material fact" is a fact that would reasonably be expected to have a significant effect on the market price or value of securities.

An issuer is only permitted to offer securities on a private-placement basis in circumstances where a prospectus exemption is available. There are a variety of prospectus exemptions under Canadian securities laws, but in the context of securitization transactions, an issuer will typically rely on the "accredited investor" exemption, which provides for sales to certain institutional investors, or the "minimum amount" exemption, which provides for sales of securities having a cash purchase price in excess of a designated amount.

Depending on the prospectus exemption that is relied on, an issuer may be required to file with provincial securities regulators a post-closing report setting out certain information regarding the private placement, along with the payment of filing fees to such regulators. The filing fees vary depending on the province, with some provincial securities regulators charging a flat fee, and others charging a fee based on the proceeds raised by the issuer in their province. In addition, if an offering memorandum is provided to investors, some provincial securities regulators require that the offering memorandum be filed with them.

Canadian Wrapper Exemption

In some cross-border securitization transactions, a U.S. issuer may wish to sell securities to investors located in Canada. In these circumstances, the U.S. issuer will need to comply with the disclosure requirements under Canadian securities laws as discussed above.

Historically, many U.S. issuers satisfied the disclosure requirements under Canadian securities laws by using a "Canadian wrapper", which was a document that wrapped around a corresponding U.S. offering document, and added the required Canadian disclosure. However, in 2015, Canadian securities regulators adopted several amendments to Canadian securities laws, with the aim of reducing the disclosure burden on foreign issuers.

Based on those amendments, a codified wrapper exemption is now available that allows a U.S. issuer to sell securities to Canadian investors on a private placement basis, without the need for a Canadian wrapper.

In order to access the wrapper exemption, a number of conditions must be satisfied, including that that the securities are primarily being offered for sale in the U.S., and that the Canadian investors are “accredited investors” as well as “permitted clients”. If all of the relevant conditions are satisfied, then the wrapper exemption provides relief from the requirement to add certain Canadian disclosure to a U.S. offering document. In particular, the wrapper exemption eliminates the need to disclose the availability of certain statutory rights of action under Canadian securities laws, and also the need to disclose certain relationships that could give rise to potential conflicts of interest between the dealers and the issuer.

It is important to note that the post-trade filings described above may need to be completed, even when relying on the wrapper exemption.

International Dealer Exemption

In addition to disclosure and filing requirements, Canadian securities laws also include requirements for issuers to sell their securities through registered dealers. If an issuer is in the “business of trading in securities”, which is a factual determination, then the issuer will need to retain one or more registered dealers in Canada to broker the sale of its securities, or rely on a dealer registration exemption.

In the context of cross-border securitization transactions, Canadian issuers often engage U.S. dealers to participate in the offering. As noted above, any U.S. dealer involved in the sale of securities by a Canadian issuer in Canada needs to either be (i) registered as a dealer in the province where it proposes to make sales of the securities, or (ii) relying on an exemption from the dealer registration requirement in such province.

When selling securities of a non-Canadian issuer by way of private placement into Canada, most U.S. dealers rely on what is known as the “international dealer exemption”. Under that exemption, a U.S. broker-dealer can only sell to “accredited investors” that are also “permitted clients” and that purchase the securities as principal. A U.S. dealer that relies on this exemption is required to file a form with the applicable Canadian securities regulators, submitting to the jurisdiction of such securities regulators, and appointing an agent for service of process.

In addition, U.S. dealers can also rely on the “international dealer exemption” to participate in certain issuances of debt securities in Canada (including asset-backed securities) by Canadian issuers. The dealer registration requirement does not apply in connection with an offering of a debt security of a Canadian issuer to a “permitted client”, if the debt security is denominated in Canadian dollars, or (if not denominated in Canadian dollars) it was originally offered in a primarily non-Canadian jurisdiction and a prospectus with respect to such security was not filed with a Canadian securities regulator.

Conclusion

McCarthy Tétrault LLP has significant experience in structuring and executing cross-border securitization transactions, and would be pleased to assist you in navigating through the legal considerations underlying such transactions.

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