

## CANADIAN SECURITIZATION MODEL UPHELD

Last week, the Ontario Court of Appeal released its long-awaited decision in *BC Tel*, and the Canadian securitization market breathed a collective sigh of relief. Ontario's highest court accepted the trial judge's conclusion that the one-step sale common to many Canadian securitization transactions effectively produces a "true sale" of the securitized assets.

### The Canadian Securitization Structure

For the first time in Canadian legal history, a Canadian court considered the effectiveness of the classic Canadian securitization transaction. As the Court noted, the securitization concept is relatively straightforward: a corporation raises cash by selling certain of its assets, usually trade, lease, loan or other receivables, to a special purpose vehicle (SPV) which, in turn, issues securities to investors in the capital markets to raise the purchase price of the receivables it purchased from the corporation. These securities are "structured" to enable rating agencies to accord them high investment grade ratings. In the result, the investors are able to look to the cash flow of the receivables (now owned by the SPV) to repay their securities, rather than the credit of the lower-rated corporation, and the receivables will not be property of the seller's estate should it become insolvent. As a result, investors are willing to provide funds to the SPV at relatively favourable rates, and the corporation is able to indirectly access the capital markets at a cost that may be significantly below its own borrowing costs.

The Court referred to a number of additional benefits that can flow from securitization. The financing will have an off-balance sheet effect since the liability for the borrowed funds will reside on the SPV's financial statements rather than the corporation's. Securitization can also enable a corporation to obtain financing backed by its receivables notwithstanding an agreement not to incur or secure direct borrowings (although, as discussed below, a securitization may contravene a restriction against raising debt *indirectly*). The Court also noted the potential for significant capital tax savings – an annual capital tax is levied by the federal government and a number of provinces on, among other things, *borrowed* money, and repaying loans with the proceeds of a securitization can reduce a corporation's capital taxes by several million dollars, depending on the size and term of the securitization facility.

It is readily apparent that a business will realize the benefits detailed above only if its securitization is viewed as involving a *sale* of its property to the SPV rather than a *loan* from the SPV. This was one of the critical issues before the court.

### The *BC Tel* Decision at Trial

BC Tel issued a series of bonds. The bonds had the benefit of a covenant that prohibited their redemption "by the application, directly or indirectly, of funds obtained through *borrowings* having an interest cost to the Company" lower than the bond coupon. BC Tel later securitized its receivables through RAC Trust, an SPV administered by CIBC, and used the securitization proceeds to redeem the bonds. RAC raised these funds through commercial paper borrowings that had a funding cost significantly lower than the rate on the bonds. The bond investors asserted that BC Tel had violated its

non-redemption covenant because the securitization was either (i) a *direct* borrowing by BC Tel rather than a sale or (ii) at least an *indirect* borrowing.

At trial, the Court concluded that BC Tel had complied with its agreement not to redeem through a *direct* borrowing since the securitization was an effective “true sale” of its receivables rather than a loan.

### **The BC Tel Decision in the Court of Appeal**

The Court of Appeal upheld the trial court’s conclusion that the BC Tel securitization constituted a sale of its receivables. In doing so, the Court validated the basic elements of Canadian securitization that have been utilized since their inception in the late 1980s, as well as the related “true sale” legal opinions. The decision will be a critical reference point for analyzing whether a particular securitization will receive sale treatment or be recharacterized as a loan.

In determining whether the transfer of assets under a securitization constitutes a sale, the court must determine the parties’ true intention by analyzing:

- The language of their contract, the factual matrix existing when the contract was made and their conduct in implementing the contract, and
- The substance of the transaction, rather than merely its form.

Although somewhat general in nature, these principles can be put to good use in practice. The first serves to emphasize that the terminology used to effect a transfer of assets and the parties’ actions must be consistent only with a sale, and must not carelessly include language or conduct that is suggestive of a borrowing or the giving of security. As elaborated by the Court of Appeal, the second principle is a helpful reminder that the overall legal effect of the transaction is paramount, whether or not it may share some characteristics with a secured loan.

More particularly, the Court of Appeal provided its views on a number of factors that the trial judge analyzed to determine the parties’ intention:

- Particularly “compelling” as pointing to a sale was that BC Tel did not have a “right of redemption”, i.e., the ability to reacquire its receivables except in limited circumstances.
- The Court agreed with the trial judge’s conclusions that a true sale will not be rejected simply because the SPV purchaser has no right to retain any surplus from collections of the receivables.
- On the important question of whether a sale will be found where the seller retains the “ownership risk” for the transferred property, both judicial levels agreed that recourse as to “collectibility” (e.g., a guaranty that the receivables will be paid in accordance with their terms) is consistent with a sale. Alternatively, “economic recourse” – a warranty that the buyer will receive a return of its investment plus an agreed upon yield unrelated to the receivables’ payment terms – would favour loan characterization.
- It is important to a sale conclusion that the purchase price of the assets be ascertainable from the language of the agreement and that those assets be identifiable.

- As well, by upholding the trial decision the Court of Appeal implicitly agreed that it will not be fatal to a sale determination if the seller retains responsibility for collection of the sold receivables.

### Securitization as an Indirect Borrowing

While agreeing that BC Tel's securitization included a true sale, and therefore did not involve a direct borrowing that violated its non-redemption covenant, the Court of Appeal nevertheless reversed the lower court and found that BC Tel had improperly obtained the redemption funds "indirectly" from borrowings. The Court characterized securitizations as having a "hybrid nature", since they constitute a "sale with an economic function – to raise borrowed funds".

In coming to this result, the Court provides a useful reminder that a corporation's other contracts and relationships must be carefully analyzed in order to determine the implications of a securitization. Simply coming to the conclusion that the transaction includes a sale for legal, tax and bankruptcy purposes, while important in itself, will not necessarily provide assurance that the transaction complies with all relevant restrictions, particularly those involving an indirect raising of borrowed funds.

For further information on the *BC Tel* decision, or securitization generally, please contact any of the following members of our Structured Finance Group:

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