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Blaney McMurtry
BARRISTERS & SOLICITORS LLP

Blaneys on Business

This newsletter is designed to bring news of changes to the law, new law, interesting deals and other matters of interest to our commercial clients and friends. We hope you will find it interesting, and welcome your comments.

Feel free to contact any of the lawyers who wrote or are quoted in these articles for more information, or call the head of our Corporate/Commercial group, Steve Popoff at 416.593.3972 or spopoff@blaney.com.

NEW ONTARIO LAWS SIMPLIFY PLEDGES OF SECURITIES

James Leech and Faithlyn Hemmings

The laws governing business financings in Ontario have, in part, caught up with 21st century technology and as a result, it is now easier for borrowers and lenders to use stocks, bonds and other financial assets as collateral for loans.

The change in the Ontario regime has come about by virtue of the new *Securities Transfer Act, 2006* (STA), which took effect on January 1, 2007, and companion amendments to the *Personal Property Security Act* (PPSA), and the *Business Corporations Act*, which provide rules and procedures that greatly facilitate the use of securities and other financial assets as collateral for secured lending.

The STA is a set of rules that governs the holding and transfer of securities and other financial assets in a manner that reflects modern commercial realities. Any person who sells, buys or holds securities, as well as any lender or secured party, is affected by the STA.

Key to the modern approach of the STA is that it draws a distinction between the direct and indirect holding of securities and deals separately with the resulting rights, obligations and restrictions.

An investor directly holds securities if that investor is registered on the books of an issuer or has possession of a security. The law prior to the STA dealt adequately with the direct holding of securities and for the most part remains unchanged.

In contrast, an investor in the *indirect* holding system is not registered on the books of the issuer. Rather, a securities intermediary, such as a stock brokerage, is registered on such books, and the investor has what is now called a "securities entitlement".

A "securities entitlement" is a bundle of contractual rights and property interests that an investor acquires when a securities intermediary records that it holds a security or other "financial asset" in an investor's security account. A securities entitlement cannot be bought or sold. Rather, when an investor sells a security in the indirect system, the securities entitlement of the seller is extinguished by the intermediary and a new securities entitlement is created in the name of the purchaser.

Much of the STA was designed to bring Ontario's legislative framework concerning the acquisition, holding and transfer of securities and financial assets into line with modern commercial practice. Many people who own shares, particularly shares of a public company, hold them indirectly through an intermediary; this has been the commercial practice for almost 50 years. That we now call this arrangement a "securities entitlement" will make little practical difference to the average investor. However, where an investor wishes to use those securities as collateral to secure lending, this distinction is very significant.

Prior to the STA, the law did not adequately address the rights as between an investor and a securities intermediary with respect to the indirect holding of securities. Not surprisingly, banks and other lenders were reluctant to use securities as collateral to secure loans unless they could take physical possession of such securities. Now the PPSA has been amended to streamline this process and set out rules governing attachment, perfection and priority of security interests over securities and other financial assets generally referred to as "investment property."

"The STA is a set of rules that governs the holding and transfer of securities and other financial assets in a manner that reflects modern commercial realities."

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In order for a security interest in collateral to be valid, it must "attach". In other words, the lender must have acquired rights to the collateral. A security interest attaches when a debtor signs a security agreement that contains a description of the collateral sufficient to enable the collateral to be identified. In the direct holding system, this description should describe the specific securities. In the indirect system, this description will be sufficient if it contains the terms "securities entitlement," "securities account," and "investment property," or if it describes specific underlying financial assets in a securities account. However, the use of these terms is not a requirement.

Control

The priority between competing lenders whose loans are secured by the same collateral is generally determined by the order of "perfection". A security interest in investment property may be perfected by (1) registration of a financing statement, (2) obtaining possession of the investment property, or (3) obtaining "control" of the investment property.

"Control", a new concept introduced by the amendments to the PPSA, is the most effective method of perfecting a security interest over investment property. In essence, control means that a secured party has the ability to deal with investment property collateral without further action by the debtor.

In the direct system, control depends on whether the securities are certificated or uncertificated. For certificated securities, a secured party obtains control if it takes delivery of the relevant certificate either with an appropriate endorsement or with the security registered by the issuer in the name of the secured party.

For uncertificated securities (those *not* represented by a certificate), control can be obtained by having the issuer register the securities in the name of the secured party or by obtaining a control agreement from the issuer. In the direct holding system a control agreement is an agreement among the issuer, the secured party and the debtor whereby the issuer agrees that it will comply with instructions from the secured party without further consent of the debtor.

In the indirect system, a secured party can obtain control by arranging for the securities intermediary to record the secured party as the entitlement holder or by entering into a control agreement with the securities intermediary. In the indirect system, a control agreement is made between the securities intermediary, the secured party and the debtor, whereby the securities intermediary agrees that it will comply with instructions of the secured party (for example, to sell the securities) without further consent of the debtor.

It is important to note that a control agreement either in the direct or indirect holding system need not give exclusive control to a secured party. A debtor can retain rights to give instructions, and other secured parties may obtain concurrent right to give instructions.

Priority

There are three key priority rules in the PPSA that determine priority with respect to investment property:

Control defeats non-control: a security interest perfected by control will have priority over another security interest perfected otherwise than by control;

Timing of control: where two or more competing security interests are perfected by control,

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the first in time to obtain control will have priority; and

Priority of the securities intermediary: where a securities intermediary has a security interest over a securities entitlement, it will have priority over all other secured parties unless the intermediary otherwise agrees. This is special case that applies in the indirect holding system only.

There is an additional priority rule that protects innocent purchasers who acquire securities for value without notice of any adverse claim to the securities. Key to this priority rule is that the purchaser must obtain control of the securities.

Transition

The STA came into force on January 1, 2007 and although it changed the legislative landscape (because it essentially codified existing commercial practice) the transition to the new regime was seamless. The STA does not affect any proceeding that began prior to January 1, 2007. If the security interest was perfected before that date, and would be perfected under the new rules, then no additional action is required. If the security interest would be not be perfected under the new rules, there is a four month grace period in which to take steps to have the interest perfected.

Conclusion

According to Statistics Canada, almost one-quarter of the Canadian population has investment accounts in which they hold stocks, bonds, mutual funds and other financial assets. Thanks to the STA and the consequential amendments to the PPSA, lenders now have a legislative framework in which they may confidently use those financial assets and securities as collateral for secured lending. ■

FEDS SAY THEY WILL EASE INTEREST DEDUCTIBILITY PROPOSAL – BUT TO WHAT EXTENT?

Paul Schnier

Canadian companies that borrow money to expand their foreign operations are allowed to deduct from their Canadian taxes the interest that they pay on the loans. Federal Finance Minister Jim Flaherty's budget proposal March 19 to rescind this has sparked objections and analysis in the tax and business communities that rival the scope and intensity of the ongoing debate on last fall's decision to tax income trusts.

The discussion on the interest-deductibility measure has been considerable and the finance minister has stated that he is prepared to moderate the timing of his plan and some of the detail. The question is, where will he determine that the public-interest balance point lies as between Ottawa's revenues and corporate Canada's global competitiveness?

A bit of a crash course on international taxation will help illuminate the issues. Under the Canadian tax system, the earnings of foreign affiliates of Canadian entities generally fall into two categories – foreign accrual property income (FAPI), which is bad, and active business income, which is good.

If FAPI is earned by a controlled foreign affiliate, it is taxed immediately in the Canadian entity. On the other hand, where active business income is earned in certain jurisdictions (generally those with which Canada has a tax treaty), this income falls into a category of earnings called "exempt surplus" and can be brought back to Canada tax free.

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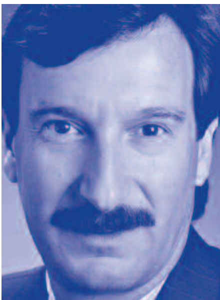

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Canadian multinationals – and not just the big ones – can therefore borrow money in Canada and deduct the interest when financing a foreign affiliate whose income is not subject to Canadian tax. There is an obvious tax advantage to this.

The March 19 budget proposes to restrict the deduction of interest in these circumstances. Under the proposal, only interest paid in excess of the exempt surplus received will be deductible, and then, this interest will be deductible only when, and to the extent that, the Canadian entity receives taxable earnings from its foreign affiliate. In other words, little, of any, of this interest expense will be deductible in the future.

There has been a large hue and cry about this proposal from Canadian multinationals as well as the tax community. They have insisted that the provision would give a marked competitive advantage to foreign concerns operating in foreign jurisdictions where Canadian companies also operate because it would increase the Canadian companies' cost of doing business.

A recent headline suggested that this will cost the Canadian economy billions vs. millions. All of this remains to be seen. What is clear, however, is that if the proposal is implemented as laid out originally, a significant advantage will be lost to Canadian entities that operate abroad.

Recently, Finance Minister Flaherty announced that while the policy itself will stand, he is willing to consider changes to how the proposal is implemented, including timing. In a May 14 speech he outlined a strategy which would "focus" the proposal and has indicated that the real intent is to get at so-called "double- dipping" structures where the interest deduction is claimed in more than one entity within a corporate group. There are ways to do this without the wholesale restrictions set out in the budget.

Such alternate approaches will undoubtedly be an important part of a lengthy process of tabling proposals, accepting submissions and making amendments over the spring and early summer while leaving businesses in tax limbo, as all of this is sorted out. We will have to watch closely to see how the proposal progresses. ■

Blaney McMurtry LLP is pleased to announce

Renato Chiaradia has been admitted to the Partnership.

Renato is a member of Blaneys' Corporate/ Commercial group. He provides counsel and service on a wide range of corporate matters including the establishment of new companies, the purchases of shares and assets, secured lending and estate freezes. He also has a significant background in bankruptcy and insolvency issues. He was called to the Bar of Ontario in 1998.

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Blaneys on Business is a publication of the Business Law Department of Blaney McMurtry LLP. The information contained in this newsletter is intended to provide information and comment, in a general fashion, about recent cases and related practice points of interest. The information and views expressed are not intended to provide legal advice. For specific legal advice, please contact us.

We welcome your comments. Address changes, mailing instructions or requests for additional copies should be directed to Chris Jones at 416 593.7221 ext. 3030 or by email to cjones@blaney.com. Legal questions should be addressed to the specified author.

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