RECENT CANADIAN DEVELOPMENT ON "TRUE SALE": A PREFERED APPROACH?

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Securitization requires that a future payment stream be legally separated from the originator. If this occurs, and the originator later becomes bankrupt, the creditors of the originator will be unable to reach the future payment stream. The future payment stream will in turn be dedicated to payment of the securities issued to investors in the capital markets. One can therefore see from this explanation how much the integrity of the structure rests on this legal separation of future payment stream from originator.

The recent Canadian decision of *Metropolitan Toronto Police Widows and Orphans Fund* v. *Telus Communications Inc.*[1], decided in January 2003, represents a major breakthrough for the Canadian securitization market. BC Tel (the predecessor of Telus) used the proceeds of a securitzation transaction entered into between BC Tel and RAC Trust (an SPV) to redeem a series of bonds. The Plaintiffs argued that the redemption of the bonds unfairly disregarded the interests of the bondholders. On the redemption date, the market price of the bonds was $115 and the redemption price paid by BC Tel pursuant to the Trust Deed was approximately $103. This resulted in a substantial loss to the bondholders ($12 per $100 principle amount). The bonds were not set to mature until 2005.

The Plaintiffs attempted to attack the securitization transaction by arguing that BC Tel did not in fact sell the receivables to RAC Trust. Justice Ground clearly laid out what criteria Canadian courts would consider when deciding if an originator actually effected a genuine sale of assets to an SPV. Intention was the primary factor. The court analyzed the wording of the contract between BC Tel and RAC (the SPV). They noted the lack of references in the agreement to a loan or to security or to payments of principal or interest on a loan. The court analyzed the conduct of the parties and the 'factual matrix' (the overall context of the agreement; for example, was it in BC Tel's best interest to structure the transaction as a sale or a secured loan?).[2] Contrast this reliance on intention with the position adopted by the US. In the often quoted American decision of *Major's Furniture Mart, Inc.* v. *Castle Credit Corporation, Inc.*, the respondent's argument was that the language of the agreement expressly referred only to sales and purchases and that therefore the parties did not intend to effect a security transfer. The court's response was that "(C)ourts will not be controlled by the nomenclature the parties apply to their relationship".[3]

On the issue of determining whether an agreement is in fact a true sale, "(T)he question for the court then is whether the ***nature of the recourse***, and the true nature of the transaction are such that the legal rights and economic consequences of the agreement bear a greater similarity to a financing transaction or to a sale."[4] In *Endico Potatoes, Inc.* v. *CIT Group/Factoring, Inc.* the court seemed to adopt an excessively economic

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[1] [2003] O.J. No. 128
[2] Ibid 1, 9.
[3] 602 F.2d 538; 1979 U.S. App LEXIS 13808, 7.
[4] Ibid 3, 9.

approach to the question of true sale, as opposed to an intention-based approach.[5] The court also placed a great deal of emphasis on risk, i.e. the amount of ownership risk transferred to the purchaser. In a sale of accounts receivable, there is always a risk that the obligor will not pay. If this risk is not fully transferred to the SPV, US courts have held that a true sale cannot exist. The reasoning is that all the risk has shifted to the originator while the SPV incurs none of the risks or obligations of ownership.

In *Metropolitan Widows* the court also emphasized the risk factor. However, Justice Ground noted that "(I)n both British and Canadian authorities it has been held that even full recourse is not incompatible with a concept of a legal sale."[6] The court then proceeded to cite an English decision (*Welsh Development Agency* v. *Export Finance Co.*) which found that although no real risk passed from the seller to the purchaser, the transaction was nonetheless one of sale. Canadian and English courts therefore appear to acknowledge a true sale where the only risk (albeit a remote one) to the SPV is a bankruptcy of the originator. The result has been that a risk of recharacterization, i.e. that a purported sale will be recharacterized as a secured loan, has not arisen much in Canadian law.

Thus it is much easier to get a true sale opinion in Canada than in the US. Indeed, this point is clearly illustrated by the attempt in the US to pass a bankruptcy reform bill which would have created a legislative "safe harbour" regarding what constitutes a true sale. The Bankruptcy Reform Act proposed to amend a section of the Bankruptcy Code by

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[5] *Endico Potatoes, Inc.* v. *CIT Group/Factoring Inc.* 67 F.3d 1063; 1995 U.S. App. LEXIS 27759. 7.

[6] Ibid 1, 11.

eliminating from a debtor's estate any 'eligible asset' transferred to an 'eligible entity' in connection with an 'asset-backed securitzation'.[7]

Under the Act any transfer in which the debtor represents (in writing) that the assets in question are "to be sold, contributed or otherwise conveyed with the ***intention*** of removing them from the debtor's estate will, under bankruptcy law, accomplish such removal."[8] Also, the Act proposes the elimination of the substantive law criteria on what constitutes true sale; for example, the amount and nature of the SPV's recourse against the originator and whether the originator has any right to reclaim the transferred receivables have been effectively eliminated.[9] Note how the proposed reforms contained in the Act mirror the current position of Canadian and UK courts on the issue. Unfortunately, the provision of the Bankruptcy Reform Act that would have created this true sale "safe harbour" was withdrawn by Congress in 2002. This was a direct result of the Enron fiasco and concerns over the use of SPV's.[10]

Along with simplifying the securitization process, the safe harbour provision would have saved the various parties involved a large amount of money. This in turn would have opened the structure up to mid-size and smaller companies. The fact that it is so difficult to get a true sale opinion in the US forces companies to utilize a two-tier structure with, for example, a New York master trust as well as an intermediary securitization SPV in an offshore jurisdiction. This will add significantly to transaction costs. Because of the relative ease of obtaining a true sale opinion in Canada, Canadian

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[7] Schwarcz, *The Impact of Bankruptcy Reform on "True Sale" Determination in Securitzation Transactions*, 7 Fordham J. Corp. & Fin. L. 353. 2.
[8] Ibid 7, 3
[9] Ibid 7, 3.
[10] Ibid 7, 1.

companies can set up a simple one-tier structure[11] (at a reduced cost), for example an Ontario corporation can create a Canadian Business Corporations Act corporation as an SPV in Ontario.

In *The Impact of Bankruptcy Reform on "True Sale" Determination in Securitization Transactions*, Schwarcz notes that "(I)f the originator also has the right to take back any surplus collections once the transaction has ended, the one-tier structure may replace the two-tier structure".[12] Under Canadian and English law, it is very likely that the originator would be able to take back surplus amounts once the transaction has ended. Even though this feature would normally be indicative of a mortgage arrangement, UK case law has held that it is not necessarily inconsistent with a sale.[13] It is therefore quite possible that the Canadian one-tier approach could someday replace the expensive and unnecessary two-tier approach of the US. Indeed, many proponents of bankruptcy reform (and securitization) in the US would probably see this as a welcomed adjustment.

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[11] Fingerhut, *The State of Canadian Securitization*, Canadian Treasurer, August/September 2000. 15.
[12] Ibid 7, 4.

[13] Raines and Wong, *Aspects of Securitization of Future Cash Flows Under English and New York Law*, 12 Duke J. Comp. & Int'l L. 453, 4. See also *Welsh Development Agency* v. *Export Finance Co.* as considered in *Metropolitan Toronto Police Widows and Orphans Fund* v. *Telus Communications Inc.*