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Supreme Court of Canada Gives the PPSA a Boost

by Cal Johnson, Q.C.



Introduction

In what is surely to be a landmark decision in resolving priority of security issues concerning personal property, the Supreme Court of Canada has squarely backed the provincial Personal Property Security Acts (“PPSA”) over the provisions of section 428 Bank Act security.

The Debate

Ever since the PPSA legislation was introduced, there has been some unresolved uncertainty over the proper approach to be taken when one lender has taken security under Provincial PPSA legislation and a competing lender has subsequently taken security in the same assets under the assignment provisions of section 428 of the Bank Act. A suggested priority analysis was proposed by the Saskatchewan Court of Appeal as far back as 1994¹. Academic writers such as Cuming, Walsh and Wood in their text on Personal Property Security Law² have made their own arguments as to the proper treatment. However it has fallen to the Supreme Court of Canada in the newly released (November 5 2010) decision in *Bank of Montreal v. Innovation Credit Union*³ to resolve the debate. In this case, the various levels of court hearing the matter were faced with a battle under Saskatchewan’s PPSA over a security interest in farm equipment taken by a credit union under the PPSA and a subsequent section 428 Bank Act assignment taken by BMO over some of the same property. The Credit Union failed to register its security interest under the PPSA until after BMO had taken its section 428 Bank Act security. Upon default, BMO seized secured property and sold it under its Bank Act security.

The Supreme Court went to great pains to examine the fundamental nature of PPSA legislation and the nature of the rights granted to a security holder as well as the rights retained by the debtor.

The Issues

This set up issues on two different fronts. First and foremost, which of the two legislative regimes would prevail? Secondly, did the fact that the Credit Union failed to register its security make a difference in the priority battle?

The Decisions

At trial the Saskatchewan Court of Queen's Bench focused on the non-registration of the PPSA security interest of the Credit Union. It ruled in effect that since the Credit Union failed to register its security, the Bank Act gave priority to BMO. This Court would have given priority to the Credit Union if it had registered first.

Upon appeal, the Saskatchewan Court of Appeal found that the Bank Act provisions did not resolve the issue. It reverted to a long established common law principle that a debtor cannot grant any better title than it has—effectively saying that when BMO took its security it acquired only such rights and title as its debtor had—i.e. subject to the rights disposed of to the Credit Union.

Upon further appeal to the Supreme Court of Canada (the “Supreme Court”), the Supreme Court recognized that validly created federal security interests cannot have their priority affected by Provincial legislation. In turning to the Bank Act for guidance, the Supreme Court was only able to find a priority rule that dictated the section 428 security would have priority over *subsequently* acquired rights in the same property. The Supreme Court then looked to other provisions in sections 427 and 435 to conclude that the Bank could acquire no greater interest in the collateral than the debtor itself had at the relevant time.

The Fallout

The Supreme Court went to great pains to examine the fundamental nature of PPSA legislation and the nature of the rights granted

to a security holder as well as the rights retained by the debtor. BMO attempted to argue that the PPSA does not grant a security holder an interest that would affect the title to the collateral, unlike the Bank Act which, in respect of certain types of collateral such as farm equipment, does in effect pass title. In reviewing the jurisprudence the Supreme Court rejected this concept and reinforced the notion that the PPSA creates more than a floating charge—it creates a charge more in the nature of a fixed charge. The Supreme Court ruled that the lack of registration was a red herring—the lack of perfection by registration is a priority issue only for competing interests under the PPSA and not where a federal security interest is involved. While the Province in creating its PPSA could have allowed for the registration of section 428 security interests, it had not done so, and indeed most PPSA expressly exclude the application of the legislation to “a security agreement governed by an Act of the Parliament of Canada...”

The Supreme Court acknowledged the untenable position in which this puts a Bank taking section 428 security where a security interest has been granted but not registered. The Bank, in the absence of disclosure by the debtor, has no way of finding out that it could not acquire a first priority security interest. The Supreme Court suggested that, while this highlights the need for legislative reform, the harshness of the result did not alter the rationale for the legal conclusion.

Footnotes

¹Royal Bank of Canada v. Agricultural Credit Corp. of Saskatchewan (1994), 115 D.L.R. (4th) 569

²Ronald C.C. Cuming, Catherine Walsh & Roderick J. Wood, *Personal Property Security Law*, 5th ed (Toronto: Irwin Law, 2005).

³[2010] S.J.C. No. 47

I am not

What Does the Common Law Say?

Generally, the law does not allow someone to enforce the provisions of a contract unless that person is a “party” to the contract—i.e. he/she signed it. Similarly, a contract cannot impose liabilities on anyone except a party to it. These concepts are commonly referred to by lawyers as the doctrine of “Privity of Contract”.

The Problem with Privity

The problem with Privity is that it often frustrates the intentions of the parties to the contract who legitimately want to confer a right or benefit on a third party. For example, a health club might agree with one of its members to offer reduced rates to all members, but only that member is an actual party to the contract. If the doctrine of Privity is applied strictly, the other members of the health club (who the law would classify as “third party beneficiaries” may be left without recourse even though the contract clearly intended a benefit to flow to the third party beneficiaries. It is inconsistent with the reasonable expectations of all the parties to the transaction, including the third party beneficiary.¹

Examples of how Privity can be an Issue in Banking Law

(a) Indemnity Clauses

A common example of privity in the context of banking law involves standard indemnity clauses in a credit agreement to the effect that the borrower agrees to indemnify the agent, the lenders and their various personnel against liabilities which may arise out of their

a party to the Contract but can I still enforce it?

by Byron Chan

role in connection with the credit agreement. While the borrower, the agent and the lenders will be a party to the credit agreement, it is unlikely that the parties' respective directors, officers, employees and agents will be party to the agreement. They would, thus, be considered third party beneficiaries because the agreement confers a benefit on them, i.e., indemnification, even though they are not party to it.

The Principled Exception

The Supreme Court of Canada has carved out a "principled exception" to the traditional Privity concept. It was most recently enunciated by that Court in the 1999 case of *Fraser River Pile & Dredge Ltd. v. Can-Div Services Ltd.*² The Supreme Court established the test for whether a third party would be allowed to benefit from a contract as follows:

1. Did the parties to the contract intend to extend the benefit in question to the third party seeking to rely on the contractual provision?
2. Are the activities performed by the third party seeking to rely on the contractual provision the very activities contemplated as coming within the scope of the contract in general, or the provision in particular, again as determined by reference to the intention of the parties?³

Accordingly, as long as the relevant director, officer, employee or agent is acting within the scope of his/her duties, he/she will likely fall within the "principled exception" and be able to rely on the indemnity clause. However, the scope of the "principled exception" is unclear. Some subsequent lower court decisions have interpreted

the "principled exception" narrowly such that it could only be used by a third party as a shield, not a sword. In other words, the exception would only allow a third party to rely on a provision in a contract to which it is not party in its defence. It would not, however, allow a third party to sue on the contract to enforce its rights. Others have interpreted the exception more broadly and have allowed third parties to sue on a contract. Regardless of the interpretation, it is best practice to avoid any potential uncertainties by explicitly identifying the third party/parties intending to benefit from the contract.

(b) Subordination of Debentures

Convertible debentures and other publicly issued securities often provide for the debt of the issuer to be subordinated to the payment of other indebtedness of the issuer. In this situation, the governing document is usually between the issuer and the debenture trustee. The other debt holders of the issuer ostensibly receiving the benefit of subordination are not party to that agreement and, thus, the doctrine of Privity presents an issue of whether the other lender(s) can enforce its rights pursuant to the subordination.

Again, the ability to enforce is linked to the clarity with which the two Supreme Court tests set out above can be met. In some instances, the other lender will rely on a confirmation of subordination provision in the trust indenture which authorizes and directs the debenture trustee to take such action as may be necessary or appropriate to effect the subordination. Alternately, the other lender may rely on a separate confirmation from the debenture trustee that confirms the right to the

benefit of the subordination. Either case speaks to the importance of explicitly identifying the rights of the other lender(s) and leaves little uncertainty as to the intention of the contracting parties to subordinate the debentures in favor of the other lender(s).

Indeed, this is confirmed through legislation. Section 40 of the *Alberta Personal Property Security Act*⁴ states:

"A secured party may, in a security agreement or otherwise, subordinate the secured party's security interest to any other interest, and the subordination is effective according to its terms between the parties and may be enforced by a third party if the third party is the person or one of a class of persons for whose benefit the subordination was intended" [emphasis added].

Conclusion

While the trend, both in legislation and in case law, seems to be moving towards a more expansive application of Privity to include third party beneficiaries, the scope of the "principled exception" remains sufficiently unclear that it is still best practice to be explicitly clear as to who the third parties are and as to the benefit intended to flow to them.

Footnotes

¹ *London Drugs v. Kuehne & Nagel Investments*, [1992] 3 S.C.R. 299 at para. 62.

² [1999] 3 S.C.R. 108

³ *Ibid.*, at para. 32.

⁴ R.S.A. 2000, c.P-7

PPSA How Do We Figure

by Simina Ionsecu-Mocanu

Introduction

The introduction of the *Personal Property Security Act*¹ (the “PPSA”) made the lives of both debtors and creditors much simpler where security is involved. Unfortunately, uncertainty remained in relation to where to register security notices in certain circumstances. In most cases, the law calls for the registration in the Province where the *goods* are located and that law will determine whether the security interest is valid and what priority it will have.

However, for security on certain other assets (including intangibles, vehicles, shares and money), the *debtor’s* location becomes the governing jurisdiction. Registering in the proper jurisdiction—and ascertaining the debtor’s correct location—is therefore crucial for secured parties holding interests in these types of collateral.



Out Where To Register?

Determining the Debtor's Location in Alberta

In Alberta, the PPSA deems a debtor to be located at the debtor's:

- (i) **place of business** if the debtor has a place of business;
- (ii) **chief executive office** if the debtor has more than one place of business; and
- (iii) **principal residence** if the debtor has no place of business.²

Finding out a debtor's proper location under existing legislation is challenging since the PPSA does not define "chief executive office." Consider the following scenario:

...A British Columbia company has its registered or head office in Toronto, has offices in three other Canadian provinces, including executive offices in *Calgary* and *Regina*, and is controlled from the head office of its parent corporation in *Denver*.

Which of these offices is the "chief executive office"?

As a result of this uncertainty, the common and safe practice for Alberta lawyers is to register security interests in *all* jurisdictions where the debtor *could* have a "chief executive office."

Ontario Amendments

The provisions of Ontario's Personal Property Security Act³ ("the Ontario PPSA") in these matters are very similar (if not identical) to those in Alberta.

In 2007, the Ontario Government enacted the *Ministry of Government Services Consumer Protection and Service Modernization Act*, 2006. This statute introduced a series of significant amendments to the Ontario PPSA. The amendments affecting location of debtor rules under the Ontario PPSA have yet to be proclaimed into force.

Once amended, the Ontario PPSA's location of debtor rules will be more similar to those in Article 9 of the U.S. Uniform Commercial Code. Secured

parties may have an easier time determining a debtor's location because they will be able to ascertain it based on the debtor's jurisdiction of formation. The new rules determine location as set out in the chart below.

When Will these Amendments Come into Force?

The location of debtor amendments are not currently in force in Canada. The general view appears to be that provincial legislators in Ontario, British Columbia, and Saskatchewan want to wait for other Canadian jurisdictions to enact similar legislation before proclaiming the amendments into force.⁶

Will the Alberta Government Enact Similar Legislation?

To date, Alberta has not introduced corresponding legislation and the Provincial Government has yet to reveal an intention to address the issue.

Conclusion

The Ontario, British Columbia, and Saskatchewan amendments to location of debtor rules in personal property and security legislation would bring a welcome level of certainty to secured lending transactions. Unfortunately, the proposed amendments will likely not come into force immediately. In the interim, the recommended practice continues to be a cautionary approach. Secured parties who wish to protect their interests should obtain as much information about their borrowers as possible and register their security in *all* jurisdictions where the debtor *could* have a chief executive office.

Footnotes

¹ *Personal Property Security Act*, R.S.A 2000, c. P-7

² PPSA, s. 7(2).

³ *Personal Property Security Act*, R.S.O. 1990, c. P.10

⁴ If provincial/ territorial laws require disclosure of incorporation, continuance, amalgamation, or organization in a public record.

⁵ If federal laws require disclosure of incorporation, continuance, amalgamation, or organization in a public record.

⁶ R.H. McLaren, 2010 *Annotated Ontario Personal Property Security Act* (Toronto: Thomson Canada Limited, 2009) notes that the Ontario Government has delayed proclamation until a "substantial number" of provinces enact similar legislation (at p. 107).

Debtor Type	Location
<ul style="list-style-type: none"> • individual 	<ul style="list-style-type: none"> • principal residence
<ul style="list-style-type: none"> • partnership <i>*other than a limited partnership</i> 	<ul style="list-style-type: none"> • jurisdiction governing the partnership agreement (if governed by a particular jurisdiction)
<ul style="list-style-type: none"> • corporation, limited partnership, or organization, incorporated, continued, amalgamated, or otherwise organized under provincial or territorial laws⁴ 	<ul style="list-style-type: none"> • jurisdiction of incorporation, continuance, amalgamation, or organization
<ul style="list-style-type: none"> • federally incorporated, continued, or amalgamated corporation⁵ 	<ul style="list-style-type: none"> • jurisdiction of registered or head office, as set out in the corporation's constating documents or bylaws (if no constating documents)
<ul style="list-style-type: none"> • trust 	<ul style="list-style-type: none"> • jurisdiction governing the trust instrument (if governed by a particular jurisdiction); OR • (otherwise) principal jurisdiction where the trustees carry out the trust's administration
<ul style="list-style-type: none"> • otherwise (that is, if none of the above apply) 	<ul style="list-style-type: none"> • debtor's chief executive office

Amalgamations

Should Alberta Worry About Reversals?

by Esther Kim, Student-at-Law

Introduction

If a Canadian amalgamation is completed in accordance with the relevant statute, it is typically permanent and irreversible, unless the statute provides this right of reversal—there is no such provision in Alberta.¹ However, a recent 2010 Ontario Court of Appeal decision, *TCR Holding Corp. v. Ontario* (“*TCR Holding*”), set aside an amalgamation relying on a “superior court’s equitable jurisdiction to relieve persons from the effect of their mistakes”.² This reliance on “equity” to reverse a completed amalgamation has given some pause for thought.

Setting Aside an Amalgamation – 45 Years in the Making

Prior to *TCR Holding*, the 1964 Supreme Court of Canada decision in *Norcan Oils Ltd. and Gridoil Freehold Leases Ltd. v. Fogler*³ (“*Norcan*”) had for many years been accepted as authority for the irreversibility of statutory amalgamations. However, over the years, the contrary views expressed by the dissenting judges in *Norcan*, seemed to be gaining momentum.

In *TCR Holding*, an amalgamated corporation successfully applied for an order to reverse an amalgamation with three of its subsidiaries. *TCR Holding Corp.* (“*TCR*”) effected the amalgamation on the mistaken assumption that the subsidiaries had no liabilities. However, one of the subsidiaries had an outstanding obligation pursuant to a guarantee on a promissory note, which the amalgamated entity now assumed.

TCR applied to set-aside the amalgamation because it never intended to assume those obligations. Creditors of the indebted subsidiary opposed the order to set-aside the amalgamation as the amalgamation gave them a possible source of recourse to collect on outstanding debts they would not otherwise have had.

In making its decision to set-aside the amalgamation, the Ontario Court of Appeal (“the Court”) relied on the following factors:

1. Each director of an amalgamating corporation had a statutory requirement to submit a statement that their respective subsidiary companies were solvent prior to the amalgamation⁴ and in this case it was done on the assumption that each had no liabilities. The Court found that the amalgamation was based on a mistake that the applicable subsidiary was debt-free.
2. Directors must also make a statutory declaration that no creditor will be prejudiced by the amalgamation.⁵ Here, the amalgamation resulted in no prejudice to the creditor. In fact, the Court determined that the amalgamation resulted in a windfall benefit to the creditor which arose through an inadvertent mistake. Accordingly, there was no prejudice to the creditor or any other party (the newly amalgamated *TCR* had not entered into any third party contracts) in setting-aside the amalgamation.
3. The Court agreed with the trial judge who had exercised equitable jurisdiction to relieve the amalgamated corporation from the effect of its unintended mistake.⁶ The Court determined that the appropriate remedy was to set-aside the amalgamation by correcting the mistake retroactively to the date of the amalgamation, thereby cancelling the certificate of amalgamation.⁷

Not All Jurisdictions are the Same

While the principles of equity may apply in a similar fashion in Ontario and Alberta, the effect of the remedy may differ based on a jurisdiction’s legislation. As a result, caution should be used

when considering decisions based on foreign legislation. There are differences between the Alberta and Ontario statutes.

The Ontario statute provides authority to order the *cancellation* of any certificate, inclusive of amalgamation certificates, which ceases to be in effect from the date fixed in the order, if sufficient cause is shown.⁸ Furthermore, sufficient cause includes conduct described as oppressive or unfairly prejudicial.⁹

The Alberta statute has no similar provision. In fact, in Alberta a claim under the grounds of oppression and unfairness “does not confer on the Court power to revoke a certificate of amalgamation.”¹⁰ Furthermore, a 1986 Alberta decision¹¹ determined that in the absence of fraud or misrepresentation¹² the validity of the certificate of incorporation, and by extension a certificate of amalgamation, cannot be questioned pursuant to s.9 of the 1981 *Alberta Business Corporations Act*¹³:

- (2) A certificate of incorporation is conclusive proof for the purposes of this Act and for all purposes
 - (a) that the provisions of this Act in respect of incorporation and all requirements precedent and incidental to incorporation have been complied with.

However, it does provide that an Alberta court has authority to order the *dissolution* of a corporation if the corporation has “procured any certificate under this Act by misrepresentation” and the corporation will cease to exist on the date shown in the certificate of dissolution.¹⁴

Based on Ontario’s legislation, the effect of cancelling a certificate can be retroactive, suggesting that a certificate can be set-aside as if it never came into existence, as in *TCR Holdings*. Absent any similar cases or legislation in Alberta



Unpaid Dividends in an Insolvency

A Claim in Debt or Equity?

By Kerry McGinnis, Student-at-Law

It is a well established principle in an insolvency that a shareholder's right to a return of its invested capital ranks behind the claims of creditors. Dividends present an interesting scenario given their dual nature. That is, a dividend is considered equity up until the point it is declared by the Board of Directors but once the dividend is declared, it becomes an unsecured debt owed to the shareholder. In an insolvency, unpaid but declared dividends rank equally with other unsecured creditor claims. In a recent Alberta decision, *JED Oil Inc. (Re)*¹ ("JED"), the Court addressed the challenge by a group of preferred shareholders to these accepted principles.

The JED Decision

JED was granted relief under the *Companies' Creditors Arrangement Act*² (the "CCAA") on August 13, 2008 with an agreed insolvency date of February 1, 2008. A group of preferred shareholders submitted a claim as unsecured creditors relating to accrued dividends they alleged were payable over a six month period. In response, a group of unsecured creditors brought forward an application contending that the dividend claims of the preferred shareholders were not debt, but equity, as the dividends had only been accrued and not declared by the Board of Directors.

Under Alberta's *Business Corporations Act*, when a corporation is insolvent it is prohibited from declaring or paying dividends.³ The unsecured creditors argued that, given JED's insolvency during the six month period in question, JED's Board of Directors had no authority or capacity to declare dividends. The unsecured creditors argued instead that the Board had accrued the quarterly dividend and deferred payment indefinitely. The preferred shareholders maintained that the dividends were declared prior to the date of insolvency but that the dividends did not become due until after the insolvency date.

Ultimately, the Court held that the only way to find in favour of the preferred shareholders would be if the dividends had been declared prior to the date of insolvency. Upon a close examination of the preferred share provisions, the wording simply could not support such a radical finding. The Court noted that by nature shareholders are "risk takers, not creditors"⁴. In order to surmount this fact, the wording of the shares needed to be much more explicit. As a result, the Court held that the preferred shareholders claim be excluded from the unsecured creditor class.

Impact of JED

JED entrenches the proposition that in an insolvency, undeclared dividend claims are rooted firmly in equity. Only dividends that are declared prior to the insolvency date are considered unsecured debts. As a shareholder, this distinction is important particularly when the corporation in question is facing financial difficulties. By law, if a corporation is unable to meet its liabilities as they become due, a dividend cannot be declared; it can only be accrued. Should the corporation's financial situation further deteriorate to the point where it seeks relief and protection under the CCAA, the prospects of recovering any accrued dividends are slim indeed.

to this effect, the dissolution of a corporation suggests that the issuance of a certificate of amalgamation remains valid until a certificate of dissolution is ordered.

Practical Implications

Although principles of equity apply in a similar fashion in Ontario and Alberta, the remedy will differ between jurisdictions based on the applicable legislation. The Ontario court in *TCR Holdings* relied on statutory authority to cancel the certificate of amalgamation retroactively because the amalgamation was based on a mistake and the cancellation did not result in prejudice to any third party. Given the limited scope and absent similar legislation in Alberta, the outcome in *TCR Holdings* should not cause alarm in Alberta but, at the very least, it should raise concern about the attrition of *Norcan*, in light of a court's equitable jurisdiction and applicable legislation.

Footnotes

¹ *Canadian Airlines Corp.*, Re 2000 ABCA 238 at para. 24, confirming *Norcan Oils Ltd.*, *Fogler* (1964), [1965] S.C.R. 36 (S.C.C.).

² *TCR Holding Corp. v. Ontario*, 2010 ONCA 233 (at para. 26 quoting 771225 *Ontario Inc. v. Bramco Holdings Co.* (1995), 21 O.R. (3d) 739 (C.A.) at p. 741.

³ [1965] S.C.R. 36 (S.C.C.)

⁴ *Ontario Business Corporations Act*, R.S.O. 1990, c. B.16 (OBCA), s. 178(2)(a)

⁵ *Ibid.*, s.178(2)(b)

⁶ *Supra* Note 1.

⁷ *TCR Holding Corp. v. Ontario*, (2009) 64 B.L.R. (4th) 139 (Ontario Superior Court of Justice) at para. 36.

⁸ OBCA s.240(1)(b)

⁹ *Ibid.*, s.240 and s.248(2).

¹⁰ ABCA., s.242(4)

¹¹ *Strachan v. MacCosham Administrative Services Ltd.*, (1986) 46 Alta. L.R. (2d) 146 (ABQB)

¹² Section Alberta *Business Corporations Act*, R.S.A. 2000, c. B-9 (ABCA), s.214(1)(c) – dissolution of a corporation if the corporation has procured any certificate under this Act by misrepresentation.

¹³ *Alberta Business Corporations Act*, S.A. 1981, c. B.15 – section and wording has not changed in 2000 ABCA.

¹⁴ *Ibid.*, s.214(1)(c) and (5).

Footnotes

¹ *JED Oil (Re)*, 2010 ABQB 295.

² *Companies' Creditors Arrangement Act*, S.C. 2005, c.47

³ *Business Corporations Act*, R.S.A. 2000, c. B-9 s.43.

⁴ *JED Oil* at par. 16.

Convertible Debentures & Criminal Interest Are There Risks?

By Annaliisa Bracco-Callaghan, Student-at-Law



Introduction

Section 347 of the *Criminal Code* deals with criminal rates of interest.¹ It provides that, “every one who enters into an agreement or arrangement to receive interest at a criminal rate, or receives a payment or partial payment of interest at a criminal rate ... [is subject to fines and/or imprisonment]”² The proscribed “criminal rate” is defined as an annualized rate of interest that exceeds 60%.

In 1998, the Supreme Court of Canada established that even if an agreement does not require the payment of an illegal rate of interest, if the lender actually receives a return that exceeds the criminal rate, that is illegal.³ The *Criminal Code* defines interest as, “the **aggregate of all charges and expenses**, whether in the form of a **fee, fine, penalty, commission or other similar charge** or expense or in any form, paid or payable for the advancing of credit under an agreement or arrangement...”

Section 347 was enacted to prevent and prosecute loan-sharking.⁴ Criminal prosecutions under this section are exceedingly rare. However, from a commercial perspective; s. 347 could have serious consequences for “ordinary business and consumer transactions”.⁵ Over the years, the expansive definition of interest has been interpreted by Canadian courts to include, “facility fees, standby fees, bonuses, penalties, participation fees, commitment fees and legal expenses, among others”.⁶ As a result, when the interest rate is annualized, problems typically arise in cases involving demand loans or short-term loans that require the repayment of the principal amount of the loan within a short time frame. Effectively, the longer a loan is outstanding, the lesser the possibility of having an annualized rate exceeding 60%.

Is Convertible Debt at Risk Under S. 347 of the Criminal Code?

Equity issued in relation to a loan transaction can take several forms, including: accompanying shares in debtor/issuer corporations; warrants to purchase shares in that corporation; a profit participation agreement or a royalty agreement.⁷ A form of equity commonly issued in venture capital arrangements is a convertible debenture, defined as:

[A] debt obligation issued by a corporation that entitles the holder, at [his] option, to surrender the debenture and receive some other asset—typically common shares of the issuer—at a conversion price specified in the debenture.⁸

The conversion price is usually higher than the market price of the issuer’s shares on the date on which the convertible debenture is issued. The debenture holder expects that, over time, the value of the issuer’s shares will increase in value above and beyond the set conversion price. When that occurs, a holder will typically exercise his conversion option. Consequently, “[t]he total return to debenture holders is the normal interest plus the incremental gain in the value of the shares when conversion is exercised at the conversion price (and for an amount in excess of the principal debt).”⁹

A dramatic increase in the value of the shares is a happy occurrence for both the debenture issuer and the debenture holder. However, a debenture holder has to be cautious that the total return it receives upon conversion does not exceed 60% calculated on an annualized basis.¹⁰ If it does, the issuer could rely on the doctrine of illegality and “simply refuse to honour the conversion or exchange right”.¹¹ The attractive nature of convertible debentures—namely, the possibility of a substantial increase in the value of the shares—makes these arrangements potentially vulnerable to the application of s. 347 of the *Criminal Code*.

The increase in value of shares (equity) issued upon conversion could be viewed as interest by the courts.

Possible Judicial Interpretation

No case-law to date examines instances where convertible debentures were issued as consideration for a loan. Academic writings have discussed the possibility of courts classifying the equity components of convertible debenture transactions as interest.

In 2002, the British Columbia Court of Appeal¹² held that royalty payments granted to a lender in consideration of a loan constituted interest under s. 347. Even though a criminal rate of interest had not yet been received by the lender, the borrower was entitled to stop the royalty payments when a 60% annualized interest rate was reached.

In an Alberta Queen’s Bench decision from 2004, the Court held that shares granted as consideration in a loan agreement constituted pure equity. As such, if their market value at the date of issue (as compared to the value of the loan) had exceeded 60% interest, they would have been off-side s. 347.¹³

Conclusion

The Supreme Court of Canada has embraced a comprehensive definition of “interest” under s. 347. In concept, the incremental capital gain return on convertible debentures at conversion could constitute interest and be eligible for inclusion as interest under s. 347 of the *Criminal Code*, just as the value of shares issued in consideration of a loan have been held to constitute interest.

The Supreme Court of Canada has acknowledged that s. 347 is “deeply problematic” for commercial transactions. However, as they see it, legislative action is required before they can adopt a more commercially reasonable interpretation of s. 347.¹⁴ Until then, when dealing with convertible debt, “conservative practitioners may advise their lending clients to include the value of the equity components in determining whether the proposed compensation offends s. 347.”¹⁵ This advice certainly applies to instances where pure equity instruments are issued at the same time as the debt is incurred. However, where that equity “kicker” is delayed—as in a convertible debenture—the issue is necessarily much less capable of determination. Issuers of convertible securities including both debt and equity will need to be sensitive to possible issues arising at the time of conversion.

Footnotes

¹ R.S.C. 1985, c. C-46, s. 347.

² Bradley Crawford, *The Law of Banking and Payment in Canada* (Aurora: Canada Law Book, 2010) at 1-64.

³ *Degelder Construction Co. v. Dancorp Developments Ltd.*, [1998] 3 S.C.R. 90.

⁴ C.J. Shaw, “Criminal Interest Rate has Zero Tolerance for Commercial Reality” (2005) 24 *Nat’l Banking L. Rev.* 29 at 30.

⁵ *Ibid.*, at 29.

⁶ Wilfred M. Estey, *Legal Opinions in Commercial Transactions*, 2d ed. (Toronto and Vancouver: Butterworths, 2002) at 232.

⁷ Barry Tarshis, “Is Equity a Crime? Equity as Interest under Section 347 of the Criminal Code” (2006) 21 *BFLR-CAN* 505 at 509.

⁸ Christopher Nicholls, “Protecting Goliath from David: Criminal Rate of Interest and Finance Transactions After Garland and Degelder” (2000) 15 *BFLR-CAN* 249 at 264.

⁹ C.J. Shaw, “Criminal Interest Rate has Zero Tolerance for Commercial Reality” (2005) 24 *Nat’l Banking L. Rev.* 29 at 35.

¹⁰ *Ibid.*

¹¹ Nicholls, *supra* note 9 at 267.

¹² *Boyd v. International Utility Structures Inc.*, 2002 BCCA 438.

¹³ *Bearcat Exploration Ltd., Re*, 2004 ABQB 601, [2004] A.W.L.D. 532.

¹⁴ Nicholls, *supra* note 9 at 270.

¹⁵ Tarshis, *supra* note 8 at 527.

BD&P and Habitat for Humanity

BD&P is thrilled to announce it is house sponsor of the *Women Build 2010*, only the 2nd All Women build in the Calgary Metropolitan area. Numerous women have participated in All Women Builds in other Canadian cities — 42 such builds in Canada since 2006! BD&P is excited to take part in this groundbreaking act of kindness, from women to women.

Construction commenced in November, 2010 in the New Brighton neighbourhood in southeast Calgary. Twenty-one female lawyers and staff from BD&P took part in framing day on Monday, November 15th raising the four exterior walls and framing the main floor of the home. Many new skills were learned and it was with great satisfaction that our BD&P group witnessed the progress made by their cumulative efforts and had the opportunity to meet the new homeowners, a young couple with two young sons. Other women from different organizations in the City of Calgary took part in further completion of the home during the balance of the week.



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