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IT'S A JUNGLE OUT THERE!

Presented by

David Chaiton
Torkin Manes Cohen Arbus LLP

The last few months drew a familiar response from the Commercial Paper markets to the age-old problem of "uncertainty": hesitancy, suspicion and caution. We all know what to expect and how things are supposed to function when the market is buoyant, unblemished by the expression of any doubt of the quality of its products—that end of the spectrum is easy to live with. Similarly, if the market is in freefall, that too, unhappily, is at least unambiguous. But any blip or murmur that is unanticipated, at least at the particular moment it occurs, is followed almost inevitably by an extended period of diagnosis and assessment, in which conventional hypotheses are challenged. Discrepancies between theory and practice begin to reveal a growing gap between underlying assumptions and the way these deals are really done. Then follows a round of speculation that causes everything to grind to a halt while the analysts figure out exactly what's wrong, how bad it is and how or if it can be fixed, and while the economy is poked and probed it lies in suspense as anxiety-ridden investors conjure up every possible disaster scenario and their plans for each of them. Unsure what response to make, then as in the game of Blackjack, sometimes it just makes sense to "hold."

Just the other day I was watching Mutual of Omaha's Wild Kingdom and marveled as the herd of wildebeest lunged headlong into crocodile infested waters to cross to greener pastures. Yes, there would be a toll paid this day, but the herd would survive. Anyway, they've been doing this forever so who are we to criticize the process? It's nature's own culling process and it ensures the survival of the species.

The herd instinct that overtakes the capital markets from time-to-time is a dominant influencer of its output, and we turn to the animal kingdom for descriptors like "Bull" or "Bear" to provide colour to its ebb and flow, to its willingness to commit for the long haul or go into hibernation, both attributes constantly struggling for supremacy.

But we're not here to talk about the common behavioural bond we share with the animal kingdom; rather, our focus is to accept this phenomenon as "normal" and contemplate what specific meaning and implications it holds for our industry. In my case, I intend to examine the response reflex in the legal context, specifically insolvency laws, that might play a role in shaping market events.

Securitization of Financial Assets

In its simplest terms, a securitization transaction involves a true sale by the originator, of defined cash flows expected to arise over a fixed period of time, to one or more special purpose companies or Special Purpose Vehicles ("SPV's"). The SPV funds the purchase price by the issue of securities, such as commercial paper, through the capital markets. Simultaneously with

Torkin Manes Cohen Arbus LLP • **Barristers** & **Solicitors** • 151 Yonge Street, Suite 1500, Toronto, ON M5C 2W7
Contact David Chaiton: Tel: 416 643 8814 Fax: 1 888 603 4585 E-mail: dchaiton@torkinmanes.com
torkinmanes.com

the purchase, the SPV assigns or charges its rights to a trustee, which holds the rights on behalf of the investors as security for their investment. By means of various forms of credit enhancement, such as subordinations, over-collateralization, liquidity facilities, credit insurance and the creation of loss reserves, the securities issued by the SPV can achieve very high credit ratings from the major credit rating agencies. This makes the securitized paper very attractive to institutional investors, such as pension funds and insurance companies, which generate huge amounts of cash on an ongoing basis and are constantly seeking high-quality investment instruments. The majority, but by no means all, of securitizations are structured so as to raise cash for the originator on an "off-balance sheet basis" and for this to be achieved, it is essential that there be no connection in ownership or management terms between the originator and any SPV. Over the last 15 to 20 years, FASB rules have evolved with a quickening pace to flesh out these requirements in increasingly tangible ways so as to ensure that these transactions have real substance and are not disguised financings to avoid the risk of substantive consolidation of the transferor and the SPV. The question of whether a special purpose entity has standing at law distinct from its transferor is a legal inquiry that must be analyzed on a case by case basis.

Typically, the trust receives the monthly payments of the lessees under the leases or obligors under other asset classes that comprise the asset pool and uses them to pay down the notes in a pre-determined order of priority, with any excess, after deducting expenses and claims against reserves, usually flowing back to the seller. This process, often referred to as "the waterfall," defines the order of cash distributions to the various stakeholders of the trust. It establishes their respective priorities in receiving funds generated by the assets at any time and under any

Torkin Manes Cohen Arbus LLP • **Barristers** & **Solicitors** • 151 Yonge Street, Suite 1500, Toronto, ON M5C 2W7
Contact David Chaiton: Tel: 416 643 8814 Fax: 1 888 603 4585 E-mail: dchaiton@torkinmanes.com
torkinmanes.com

circumstances. As described by Andrew Lin of ScotiaMcLeod Inc. in a June 2000 paper, "Just like a real waterfall that flows down a series of steps, with a little water being trapped at each step, the asset cashflows get distributed in order of priority to fulfill various claims….Typically, trust expenses such as administration fees and trustee fees are paid first. Next, stand-by fees for liquidity lines and / or letters of credit are paid down. Then swap expenses along with repayment of principal and interest on various classes of notes are paid down, followed by top-up amounts needed to fund any cash reserves in the trust. The excess, if any, would then flow back to the seller [or the most junior noteholder, as the case may be, with the objective that] [There] should be sufficient cash flowing down the waterfall to pay down all expenses to keep the trust running and pay all notes that represent the trust's cost of funds. Each class of noteholders can look to the next lower class of noteholders, the excess spread and the reserve, if any, as credit support."

However, a securitization works only when sellers and buyers both participate. This bi-lateral relationship is often assumed or overlooked by the securitization community as the essential fulcrum mediating its raison d'etre. Most of the focus is on creating a structure that ensures the independence, or bankruptcy remoteness, of the trust and its assets from the seller. But investors are also concerned about the timeliness of their cashflows, not merely whether the cash will ultimately be paid. Apart from default and prepayment risk, even the risk of the seller's bankruptcy, there needs to be a ready, willing and enthusiastic market for these securities. Until August 13th, when a major Canadian intermediary announced it was encountering difficulties in rolling over its notes, that was virtually assumed to be the case for the simple reason that the securitization structure produces highly rated, secure paper that generates higher spreads than

Torkin Manes Cohen Arbus LLP • **Barristers** & **Solicitors** • 151 Yonge Street, Suite 1500, Toronto, ON M5C 2W7
Contact David Chaiton: Tel: 416 643 8814 Fax: 1 888 603 4585 E-mail: dchaiton@torkinmanes.com
torkinmanes.com

other forms of liquid securities found primarily in the bond market. They were a good place to "park" excess cash on a short-term basis. Until now, the focus has been on the seller's bankruptcy, or even that of the servicer, although they are often one and the same. All of the structures in use today allow the trust to replace the servicer with a new one under various conditions and even when that doesn't take place, as was the case in the Eaton's restructuring where Eaton's continued to administer its credit card receivables which had been sold to a trust that obtained a court order recognizing that they belonged to the trust and were not to be consolidated with the assets of the company thereby protecting them from the store's creditors: a solid vindication of the structure that was employed and of the reasonable expectations of the marketplace. However, that is not the invariable result. That result would likely not have been obtained if Eaton's had commingled its credit card receipts in a concentration cash management system: see for example, in the US case of Southmark Corporation, 49 F.3d 1111 (5^{th} Cir. 1995). We avoid this result these days by flowing collections to a restricted lockbox account, frequently in the name of the purchaser.

The Age of Corporate Restructuring and the Sanctity of Trust Money

The typical securitizer of leases (or of any asset class for that matter) enters into lengthy documents that "structure" the relationship among the parties in such a way as to ensure a bankruptcy remote disposition of assets to a special purpose vehicle designed to be insulated from the depredations of creditors of the originator. So, one supposes, that the insolvency of the originator has been taken out of the equation. But on closer examination this may prove to be less than axiomatic in the twilight zone of insolvency law.

Torkin Manes Cohen Arbus LLP • **Barristers** & **Solicitors** • 151 Yonge Street, Suite 1500, Toronto, ON M5C 2W7
Contact David Chaiton: Tel: 416 643 8814 Fax: 1 888 603 4585 E-mail: dchaiton@torkinmanes.com
torkinmanes.com

We all know that mysterious rules come into play when a company files for so-called “court protection.” Contracts may be disclaimed, leases rejected, obligations ignored, jobs lost, pensions liquidated, security disregarded—all to serve the greater good that is supposed to exist if the insolvent company is permitted an opportunity to restructure its affairs. And the courts exercise a broad, virtually unfettered, inherent jurisdiction in these matters that adds momentum to the uncertainty and forces us to accept the doctrine of unintended consequences as a major corollary to the exercise of a broad inherent jurisdiction with the single-minded purpose of facilitating a restructuring.

I think that many people who enter contracts, give or take security, or otherwise depend upon the courts to honour the principle of “freedom of contract,” fail to consider the impact of insolvency law as it has now evolved. Nothing is sacrosanct—a vast generalization to be sure, but who in this room isn’t alive to the fact that there’s a new sheriff in town every time a filing occurs?

Let’s examine this statement from three different viewpoints: the leasing company; the broker and the funder.

Consider the position of Leaseco A. It does about $5 Million a month in new business, has a strong credit culture and good portfolio mix. Leaseco A has grown a sustainable book of business over the years, brings in about $2 Million a year in EBITDA and has a value of perhaps as much as $10 Million or more as a going concern. But that was two months ago. Since then, the marketplace has been doing a lot of navel-gazing and a so-called “liquidity crunch” has

Torkin Manes Cohen Arbus LLP • **Barristers** & **Solicitors** • 151 Yonge Street, Suite 1500, Toronto, ON M5C 2W7
Contact David Chaiton: Tel: 416 643 8814 Fax: 1 888 603 4585 E-mail: dchaiton@torkinmanes.com
torkinmanes.com

descended. Leaseco A had been fortunate enough to have established leasing lines with institutions which regularly buy paper and hold it for its own book. Since it has a ready market for its paper Leaseco A continues in business as before, although it has curtailed plans for expansion into new asset classes and customers while it assesses the fallout from the crunch, and in particular, whether there will continue to be an appetite for this type of paper and at what incremental cost. Also, what would the impact be of a tightening of credit policy on the economy as a whole? Will the phenomenon, which for a brief moment was localized in the US subprime mortgage market, spread like nuclear fallout to other sectors? Only recently, the loss of jobs in Oshawa's GM production facility bears mute testimony to the financial ties that bind us. Will there be a broader decline, in consumer sentiment for example, that will negatively impact both the availability and fundability of quality paper?

In contrast, Leaseco B, which is in almost all respects a mirror image of Leaseco A, funds its operations by selling its leases into non-bank securitization conduits that issue commercial paper. It recently tried to fund a tranche of leases but was informed that its traditional funding source had been put on hold, at least for the time being. This created a real problem for B: it's not as though one can simply start and stop doing business on some arbitrary schedule. The leasing equation is built upon inertia, and it is an industry that is tightly wound, extremely sensitive to market perturbations. B has obligations to its vendors and brokers and its own internally generated customers. Without funding, a leasing company quickly transforms itself into an administration vehicle limited in objective to running off its own portfolio. Almost instantaneously, it sheds its sales and business development staff, functioning only as a shadow

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Contact David Chaiton: Tel: 416 643 8814 Fax: 1 888 603 4585 E-mail: dchaiton@torkinmanes.com
torkinmanes.com

of its former self. Leaseco B, in contrast to Leaseco A, loses virtually all of its value and is no longer a going concern.

Brokers, well, suffice it to say that it has suddenly become a buyer's market, so much so that the vulture funds have emerged from their redoubts expecting to feed on the sick and dying. Their appearance, as in nature, implies the onset of conditions that challenge the very survival of the inhabitants.

As you ponder the future, ask yourselves, what is in store for the non-institutional financial intermediary while this cloud of uncertainty hangs over the industry? What about the companies who fund leases with them? Where will they go to ensure uninterrupted origination and funding? Will the crisis, if there is one, be over by the time these companies exhaust their warehouse lines? In fact, will the warehouse lenders stand by idly and allow those lines to be drawn down in circumstances in which there have been materially negative market events which do not augur well for the fundability of the leases that are being generated? What legal recourse is available to the leasing companies? The funders? The financial intermediaries? And how likely is it that any of them will take a step that sends a shudder throughout the industry?

These are difficult questions, but the stark image of the wildebeest running headlong into gathering masses of feed-frenzied crocodiles is a powerful one, the animals driven by necessity to venture into unimaginably dangerous waters inhabited by predators who know a good opportunity when they see one.

Torkin Manes Cohen Arbus LLP • **Barristers** & **Solicitors** • 151 Yonge Street, Suite 1500, Toronto, ON M5C 2W7
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torkinmanes.com

Leasing companies with continuing funding sources will likely cross that river unharmed; those without may fall prey to natural market forces; others yet may quickly adapt because they have or find the resources to do so either with their ownership intact or with new players at the helm.

I've already mentioned that insolvency brings forth judicial creativity and unexpected consequences. Among these are the financial demands placed upon companies as they restructure their affairs. Financial intermediaries that provide securitization conduits perform an important role in providing funding for small and large leasing companies alike. Directly or indirectly, their presence makes it possible for small- and mid-sized businesses, even many large companies, to make significant investments in capital assets. As a reward, these intermediaries usually earn a continuous flow of spread income when the financial assets they securitize morph into commercial paper. This money is relied upon to generate a profit and fund operations, and even though the "structures" employed envisage the possibility of a change in administrator, it is a safe bet that this is a fate not ever within the contemplation of the intermediary. So, what can it do to forestall it?

I'm only speculating, of course, but these days it is unusual for a company to wither on the vine without a fight for survival, frequently in the form of a filing for court protection from creditors to get it some breathing room. Entertain no doubt that this type of legal proceeding is a very, very intensive exercise. That means it's going to be expensive, with legal fees, monitor's fees, consulting engagements and so forth eating into the available resources with total abandon in

Torkin Manes Cohen Arbus LLP • **Barristers** & **Solicitors** • 151 Yonge Street, Suite 1500, Toronto, ON M5C 2W7
Contact David Chaiton: Tel: 416 643 8814 Fax: 1 888 603 4585 E-mail: dchaiton@torkinmanes.com
torkinmanes.com

order to accomplish, with single-mindedness, the goal of nursing the company back to health in some revised condition.

Where will the money come from to support this endeavour? It's a good bet that the spread income from administration isn't going to be sufficient to pay the bills. It's also safe to say that the administrator isn't going to willingly offer up that income to a substitute administrator waiting in the wings.

The Commercial List Judges and Advisory Committee in Toronto have come up with a standard, template initial order that the profession uses on CCAA applications. It's included at Tab 3 of my booklet. Take a moment to consider the breadth of the stay of proceedings that is imposed by section 15 and 16 of the order. While you're doing so, turn your mind to other provisions, such as sections 3, 4, 7, 10, 11, 25, 30, 39 and 41. What you'll see is that it is broad enough to preclude creditors (including leasing companies expecting the repatriation of reserves on leases that have run their course) from doing anything to recover amounts earmarked for them.

More importantly, over the years, the courts have been increasingly willing to make incursions into the property of others, that is, security held by lenders as well as trust funds, if the circumstances warrant doing so in order to permit the insolvent company to restructure its affairs.

Torkin Manes Cohen Arbus LLP • Barristers & **Solicitors •** 151 Yonge Street, Suite 1500, Toronto, ON M5C 2W7
Contact David Chaiton: Tel: 416 643 8814 Fax: 1 888 603 4585 E-mail: dchaiton@torkinmanes.com
torkinmanes.com

For example, in *Robert F. Kowal Investments Ltd. et al.* v. *Deeder Electric Ltd.*, the Ontario Court of Appeal held that "in order for a receiver to have priority for its fees and disbursements over secured creditors, the secured creditors must have received notice of the application for an order giving priority to the receiver's fees." There are three exceptions to this principle:

1) if the secured creditors have approved or acquiesced in the order;

2) if the receiver has been appointed to preserve and realize the assets for the benefit of all interested parties, including secured creditors but to obtain such an order, notice should be given of the application to the secured creditors affected by it; and

3) if the receiver has expended time and money for the necessary preservation and improvement of the property.

At least one of the exceptions must be satisfied in order for the receiver to maintain priority for its fees, without having to send notice to secured creditors.

In *Ontario Securities Commission* v. *Consortium Construction Inc*. ("OSC Case"), the Ontario Court of Appeal held that "in receivership proceedings, the court has the discretion to charge trust assets with payment of a receiver's proper fees and disbursements. This discretion should, however, be sparingly exercised and, ordinarily, an order should only be made after notice to those affected by it." In the OSC Case, a group of investors (the Bahamas I investors) had delivered their money to the Consortium Group on terms that it would be held in trust until a certain stage in the development of a real estate project. That stage was never reached. Therefore, the investors argued that the funds should be maintained separately and that they

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Contact David Chaiton: Tel: 416 643 8814 Fax: 1 888 603 4585 E-mail: dchaiton@torkinmanes.com
torkinmanes.com

should only bear a limited responsibility for fees and expenses. The court did not accept this reasoning and held that trust assets could be used to cover the receiver's fees.

In *Re Residential Warranty Co. of Canada Inc.*, ("Residential Warranty"), the Alberta Court of Appeal held that "a bankruptcy court has the inherent jurisdiction to order that the fees of a trustee in bankruptcy be paid from the property that is subject to certain disputed trust claims by way of a charge against all of the assets under the trustee's administration, and that such jurisdiction includes the trustee's fees associated with the determination of the validity of the disputed trust claims."

As for the lease brokerage community, as Caesar goes, so goes Rome.

Conclusion

The so-called "liquidity crunch" may well blow over and become a non-event. But the marketplace is an unforgiving master. It will not remain patient forever. And it's clear that even if there is a recovery, the market for commercial paper has all but disappeared. Every day we read about this company or that pension fund's exposure to ABCP, as if to say, "Why did you invest so heavily in this minefield of dubious opportunity?" Any recovery that is premised on the greed factor of higher yields drawing these entities back in is, at best, wishful thinking. Furthermore, throughout the industry as a whole there is likely to be some retrenchment and rethinking of credit quality (it is worthwhile noting that throughout this affair no question has

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Contact David Chaiton: Tel: 416 643 8814 Fax: 1 888 603 4585 E-mail: dchaiton@torkinmanes.com
torkinmanes.com

been raised about the performance of underlying assets in lease securitizations), spread requirements and concentration of assets. Let’s wait and see….

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Contact David Chaiton: Tel: 416 643 8814 Fax: 1 888 603 4585 E-mail: dchaiton@torkinmanes.com
torkinmanes.com