Oh Canada!

Seeking Growth North of the Border

EQUIPMENT LEASING & FINANCE
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The Foundation is the only research organization dedicated solely to the equipment finance industry.

The Foundation accomplishes its mission through development of future-focused studies and reports identifying critical issues that could impact the industry.

The Foundation research is independent, predictive and peer-reviewed by industry experts. The Foundation is funded solely through contributions. Contributions to the Foundation are tax deductible.

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Executive Summary

Canada represents a promising opportunity for U.S. equipment finance companies pursuing growth and strategic market advantage. Many American firms have already established operations in Canada, choosing to follow customers, vendor programs or corporate directives. Others have simply desired new venues for expansion. Canada's physical proximity, along with similarities in its legal environment and use of the English language in most areas, make it a practical option for expansion. In the current period of economic rebuilding and increased global trade, however, Canada should be seen as more than a decent opportunity. It should be seen as expansion that is *required* for maintaining market share in the equipment leasing and finance business. Consider:

- ➢ The Canadian economy is currently producing good but modest growth of GDP and is driven by many of the same industries as the U.S.
- ➢ Cross-border trade and shared markets have resulted in many U.S. companies already conducting business in Canada, either directly or through subsidiaries
- ➢ Numerous top U.S. bank affiliates and captive finance companies entered the Canadian market years ago and now have more than a decade of experience
- ➢ Close historical, cultural and business ties between the two nations allow U.S. firms to test their international expansion capabilities in a friendly market that is similar and close to home.
- ➢ All G7 industrialized nations saw a decline in lease and finance assets, as well as in the penetration of leasing and finance as a percentage of capital spending on equipment and software, through the end of 2010. But data from the Canadian Finance and Leasing Association (CFLA) now shows surging lease volume in Canada, with a confirmed a 15% increase in 2011over 2010.
- ➢ As bright as the picture appears, however, legal, regulatory and in some cases, cultural, differences between the two nations must be taken into account. Knowledge of these differences, and carefully laid plans for dealing with them, are critical to a firm's expansion success.

Size

Canada is geographically large but thinly populated. Total population is roughly 34 million, which is comparable to California. An estimated 75% of Canadians live within 100 miles of the U.S. Border. Canada's economy is approximately 10% of the U.S. economy. In 2011, Canada's equipment leasing and finance industry totaled $45.2 billion. During the same period, industry transactions in the U.S. totaled $628 billion.

Organization and Government

Canada is geographically divided into five regions, each of which has cultural and economic distinctions. The regions are:

- The Atlantic Provinces (known for fishing, farming and forestry)
- Central Canada (manufacturing, finance and service)
- The Prairie Provinces (mining, oil and gas, agriculture)
- The West Coast (mining, gas, shipping, tourism), and
- The Northern Territories (mining, oil and gas).

Politically and geographically, Canada is further divided into 10 provinces and three territories. These are listed below roughly in order of their equipment leasing and finance potential.

Ontario (Central Canada) is the economic engine of Canada. With a provincial GDP nearly twice that of the second largest provincial GDP, Quebec, Ontario produces more than 60% of Canadian goods produced for export. Toronto serves as the financial hub of both Ontario and Canada. Most U.S. leasing and finance companies entering Canada choose to locate in or near Toronto. U.S. based firms who have done so include Wells Fargo, PNC, GE, CIT, CSI, Dell Financial Services, Key Equipment Finance, and Bank of America.

Quebec (Central Canada) is perhaps the most distinctive province and one of the most important. Failure to understand Quebec and how it influences the entire Canadian mindset could result in a less-than-optimal market entrance and compromised success.

The majority of Quebec residents speak French as their first or only language. Thus, French is the expected language for transactions with governmental or quasi-governmental entities. Many large international corporations are fully bilingual, but language laws may require certain transactions to be in French. Quebec's economy thrives on hydro-power, aerospace, mining, and pulp and paper. Bombardier, PACCAR, NovaBus and Komatsu maintain major presences. Canadian equipment lessors report that 30% of their leased assets are located in Quebec.

Quebecois (keb-eh-KWA) voters went to the polls in September, 2012 and elected a new minority government. The *Parti Quebecois* advocates national sovereignty for the province and secession from Canada. The party's election may lead to another referendum in Quebec, although probably not for some time. It remains to be seen what impact the change will ultimately produce, but it is vital that new entrants understand this segment of the market and its potential effects on key economic drivers.

Alberta (Prairie Provinces) lies immediately east of British Columbia and is known for huge oil reserves, entrepreneurship and conservative politics. The oil sands industry is currently driving large equipment purchases, but economic performance fluctuates with oil and gas prices. Even so, Alberta consistently outperforms most other provinces in GDP and rates of employment.

Saskatchewan and Manitoba (Prairie Provinces) bear similarities to the American Midwest. Home to the manufacture of fire and rescue vehicles, buses and vehicles used in agriculture, Manitoba also boasts large trucking and an aerospace industry. Saskatchewan is a major agricultural producer with strong demand for agricultural equipment financing. Saskatchewan has also enjoyed recent growth in oil and natural gas extraction. Neither province grabs many headlines, but both have diverse, strong economies.

British Columbia ("B.C.") occupies the entire West Coast region and contributes roughly 12% of Canada's GDP. Historically, B.C. depended on commodity markets and tourism, but over time, more of its economy has derived from services. Nonetheless, Vancouver, B.C. is considered a highly desirable place to live and fuels a strong construction industry.

Northern Canada comprises three territories: Yukon, Nunavut (established in 1999 from the Northwest Territories) and the Northwest Territories. Each is vast geographically but sparsely populated. Even so, middle-market and large-ticket equipment financiers report potential for financing high-value assets used in mining and oil and natural-gas extraction. Because many mines and extraction sites are located in remote areas, however, weather and other seasonal issues can increase the costs of doing business.

Nova Scotia, Prince Edward Island, New Brunswick, Newfoundland and Labrador (The Atlantic Region) are collectively known as the "Maritimes." Historically, the Maritime Provinces have been Canada's weakest economies. But recently, parts of the region have become major oil and gas producers, bringing a welcome boost to the region's GDP.

Influences on the Equipment-Finance Business Environment

The Canadian equipment finance market is mature, but its *players* have changed. The catalysts: the global credit crisis and subsequent global economic downturn. Prior to this decline the industry enjoyed a market penetration rate consistently over 20%. Asset values peaked in 2008 at $53.8 billion ($42.3 billion in equipment and $11.5 billion in commercial fleet). Recent data from the CFLA shows that lease penetration rate has now recovered to pre-recession levels.

The Canadian dollar (approximately $1.02 U.S. as of September 10, 2012) has climbed significantly in recent years, affecting corporate earnings. Firms entering the Canadian market need to study past and potential effects of Canadian dollar fluctuation, realizing that changes will affect the relative value of income that may later be added to U.S. financial statements.

A weaker Canadian dollar would be both a curse and a blessing for U.S. lessors operating in Canada. Canadian earnings would be subject to a reduction when converted to U.S. dollars. Yet, a stronger U.S. dollar would give U.S. companies an advantage when contemplating acquisitions or additional investment in Canada. The impact of a low Canadian dollar on repatriated income can be mitigated by a currency-hedging strategy.

Low short and long-term interest rates have started to diverge in 2012, and global uncertainty continues to make future interest rates unpredictable. The Governor of the Bank of Canada continues to state publicly that Canada may need to increase interest rates to slow growth in the Canadian economy and reduce the risk of inflation.

Canadian lease and finance portfolios perform differently from those in the U.S. Canadian entrepreneurs are more cautious than American entrepreneurs, and this is reflected in delinquency and default performance. Credit policy and the tools needed to make credit determination may require adjustments as knowledge and understanding of regional and industry credit performance are gained.

Industry Participants

Banks operate under federal legislation called the Bank Act, which is reviewed every five years to ensure that it does not impede the global competitiveness or stability of banks. Banks in Canada are divided into three types, referred to as Schedule I, II, and III Banks. All are monitored by the Office of the Superintendent of Finance Institutions (OFSI), and each type is permitted a different range of activity. Whether a finance firm entering Canada is subject to the Bank Act will depend on its ownership structure. But from a leasing perspective, the most significant Canadian bank law is one that restricts the size of residual position that can be taken by both Canadian banks and U.S. banks subject to the Bank Act. Such banks are limited to a 25% residual in any one transaction and a total residual exposure of 10% of the entire portfolio. Additionally, banks falling under the Bank Act are prohibited from leasing automobiles and trucks that fall under 21 tonnes on a load-capacity basis. Banks planning entry to Canada should also determine if specific provinces have further requirements for lending institutions.

Credit Unions operate regionally in Canada, but recent revisions to the Bank Act allow for the creation of a Federal Credit Union. Credit Unions are typically located in rural communities, are successful, and a key part of the community. Their activity within the leasing industry continues to grow.

Captives are numerous in the Canadian market and include John Deere Financial, Caterpillar, CNH Capital and Volvo Financial. The list of captives doing business in Canada continues to grow, since most global manufacturers believe they need to provide financing in all countries in which they sell.

Independents have seen their number shrink from consolidation and banks' purchase of the sales forces of several large independents. Increasing price competition in materials handling, medical, dental and other highly desirable sectors has further eroded independents' market share. There are, however, some entrants who are growing, particularly Element Financial.

Funding and Capitalization

Securitization

The credit crisis significantly halted securitization as a tool for funding finance companies in Canada, but the market is recovering. In July, 2012, CIT successfully funded a $531-million securitization of equipment leases and loans. This was CIT's first use of Canada's securitization market since 2009.

Bulk Funding/Private Securitization

Many small and mid-size independent lessors find financing through facilities funded directly or indirectly from Life Insurance Companies and smaller banks. These facilities are similar to conventional securitizations but usually have lower transaction costs and higher advance rates. Compared to traditional bank financing, these structures often have better leverage as well, and have served as cornerstones of funding for many of Canada's independent lessors.

Bank Facilities

Canadian lessors and captives have had modest success negotiating borrowing facilities from Canadian and foreign banks operating in Canada. Expectations of providers at these facilities are high: a strong balance sheet and excellent historical performance are normally required to negotiate optimal leverage and pricing.

Tax Considerations

Taxes are paid at both federal and provincial levels, but not municipally. As of September 2012, combined federal and provincial tax rates for a firm located in the Province of Ontario totaled 26.5%.

Since January 1, 2008, interest paid by Canadian borrowers to U.S. lenders is not subject to *withholding tax* if the parties deal at arm's length and the interest is not "participating." This change has improved a market that for U.S. lenders was restricted, given the added cost of withholding tax. The rule does not extend to true or finance leases.

Cross-border loans from a U.S. company to a Canadian borrower are generally subject to *mainstream Canadian taxes* when the U.S. company has a sales force in Canada. If no Canadian connection exists other than the borrower's status as Canadian, mainstream taxes don't apply.

Accounting Considerations

Until recently, accounting practices for leases in Canada and the U.S. were reasonably aligned. But in 2011 the environment became more complicated for U.S. companies entering the Canadian market. Two groups of commercial lessees were identified: those required (or choosing) to follow International Financial Reporting Standards (IFRS,) and those following the new "made in Canada" Accounting Standards for Private Enterprises (ASPE). All publicly accountable entities (those that have issued or are in the process of issuing public equity or debt instruments, regulated financial institutions, and other entities that hold assets in a fiduciary capacity for others) were required to transition to IFRS in their first fiscal year commencing on or after January 1, 2011. All other profit-oriented entities had the choice of transitioning to IFRS or ASPE as of that date.

Although differences exist, each existing lease model provides potential for off-balance-sheet operating lease treatment. Changes are on the horizon, however, via the project underway to overhaul IFRS and U.S. lease-accounting models. Under the new models, lessees following IFRS or U.S. GAAP will likely be required to show the impact of virtually *all* leases (including property leases) on the balance sheet.

Given expanding divergence in requirements between the various lease-accounting frameworks, it has become increasingly important for companies contemplating expansion into Canada to understand which model applies when selecting target markets, designing lease products, and reviewing financial performance for making final origination and pricing decisions.

Market Entry Methods

Expansion into Canada can be undertaken relatively quickly and for a low cost, relative to other foreign markets. Entry methods depend on the type of transactions to be done and the company's reasons for expansion. If only loan and security agreements are entered into, along with conditional sale agreements, it is possible to enter Canada without forming a Canadian subsidiary. If leases are transacted, some form of Canadian presence is required if withholding tax is to be avoided.

U.S. Funding of Canadian Deals in the U.S

The easiest way to enter the Canadian market is to transact business from a firm's U.S. headquarters. Without established operations in Canada, transaction costs remain low and potential legal ramifications are few. U.S. law could apply to particular transactions with the exception of those areas that must be governed pursuant to local law. Factors influencing the success of this strategy will include withholding tax concerns, regulatory concerns, requirements of clients, and marketing efforts. If transactions can be documented as loans and not leases, and a sales force in Canada is unnecessary, this entry method tends to make the most economic sense. The option is generally used for one-off transactions and is often the first encounter a finance company has with the Canadian market.

Formation of a Canadian Subsidiary

This strategy is most common among U.S. finance companies now operating in Canada. A legal operating entity is established in Canada, and management and staff are then hired to pursue the market. Operational and legal issues include Canadian Treasury and Treasury Management requirements, Canadian accounting requirements and integration to U.S. GAAP, creation of a Canadian-version lease contract, and establishment of credit and collections policies based on Canadian law.

Co-ventures with an Existing Canadian Leasing Company

U.S. firms with modest volume expectations for Canada may seek to partner with a Canadian lessor who can provide all service and support for Canadian business opportunities sourced by the U.S. company. This strategy has been effective for some firms seeking to reduce risks accompanying a full start-up. A key issue in the strategy is the establishment of non-compete and non-circumvent agreements.

Servicers

U.S. and Canadian entities exist that can provide complete portfolio servicing in the Canadian market. Use of this strategy usually reduces the risk of errors and can speed market entry. Historically, servicers achieve quick starts and have all of the issues discussed above well in hand. The strategy is most effective when the primary entry driver is provision of a leasing solution in Canada for domestic U.S. clients.

Quasi-Securitization

An alternative to establishing a Canadian subsidiary involves securitization of an existing Canadian portfolio through a cross-border loan made by a U.S. lender. If a U.S. finance company desires Canadian exposure to a lease or group of leases originated by a Canadian lessor, the U.S. finance entity can develop a loan structure to accomplish this goal. This would be a non-recourse loan to the Canadian leasing company or special-purpose entity, which could be bankruptcy-remote. Concerns that arise with the use of these structures (e.g., insolvency, inter-creditor) are discussed in the full report.

In this age of post-recessionary global expansion, cross-border growth into Canada is more than food for thought; for many equipment leasing and finance companies, it is a necessity. Increasingly, U.S.-based clients are asking domestic finance partners to provide them with solutions for client operations in Canada. Failure to do so can damage company-client relationships to the point that clients seek other finance firms for partnering in Canada—and, perhaps eventually, in the U.S. as well.

At a macro level, Canada has strong growth prospects and a solid equipment finance market. As in the U.S., the Canadian market may best be viewed not as a single entity, but as a series of smaller and distinct markets that share certain cultural values. But economic understanding alone does not provide a full picture. Sensitivity to Canada's French and English origins and its regional diversity can help U.S. firms considering entry understand how to conduct business in Canada and how to avoid common pitfalls. Basic awareness of the nation's rich, combined history and, in some areas, bifurcated allegiances, will also explain certain biases that exist in Canada and acceptable ways of navigating through them.

From both regulatory and legal standpoints, Canada is an easier place to conduct business than the U.S. A less litigious environment and insolvency provisions that are generally more creditor-friendly make it so. Once an expansion is planned, it can usually be undertaken quickly and for a cost that is low, compared to other foreign markets.

Interviews with equipment lessors and financiers revealed four drivers for expansion into Canada:

- **To follow customers** already operating in Canada and requiring equipment there. Firms involved in mining, oil and gas production, and trucking are examples
- **To follow vendor programs**: major equipment manufacturers and distributors often ask their finance partners to provide comparable programs for the vendors' Canadian sales channels
- **To follow a parent** that decides to enter Canada
- **To grow business**: Canada is a clear choice for expansion due to proximity and reputation as a friendly business environment that is similar to the U.S.

An Economic Macro-Analysis

The International Monetary Fund (IMF) ranks Canada's GDP as the world's 10th largest. Yet, the IMF reported that in 2011, Canada's GDP was 11.5% that of the United States. Canada's economy is based heavily on exportation of resources and, to a lesser extent, finished goods. Roughly 30% of the nation's GDP is generated by exports and of these, the majority are shipped to the U.S. Thus Canada is a strong market, but relies on a healthy U.S. economy to optimize growth of its GDP.

Specifically, Canada exports 74.9% of its goods and services to the U.S. High-dollar volume exports include motor vehicles and parts, industrial machinery, aircraft, telecommunications equipment, chemicals, plastics, wood pulp, timber, crude petroleum, natural gas, electricity and aluminum. Trade with the U.S. has increased over time, especially since the 1994 signing of the North American Free Trade Agreement (NAFTA). The agreement between Canada, the U.S. and Mexico eliminated significant trade barriers between the three nations and improved efficient movement of goods and services.

Figure 1: Relative Market Size

Attribute	Canada	California
Population	34.482 Million (Statistics Canada, 2011)[i]	37.7 Million (U.S. Census Bureau, 2011)[ii]
GDP	$1.6 Trillion (Statistics Canada, 2009)[iii]	$1.9 Trillion (U.S. Department of Commerce, 2011)[iv]

Currently, the Canadian GDP is experiencing good but modest growth. Many U.S. leasing and finance firms already conduct business in Canada either directly or through subsidiaries. What's more, many top U.S. bank affiliates and captive finance companies entered Canada years ago and now have more than a decade of experience. Clearly, close relations between the two countries provide an additional reason for firms to choose Canada when testing their tolerance and ability for international expansion.

Each year, the Canadian Finance and Leasing Association (CFLA) executes a survey of key industry companies. The survey is carried out by the Centre for Spatial Economics ("C4SE"), and preliminary data from the 2012 survey was generously provided by CFLA for this study. The 2012 data show that Canada's economy grew by 2.6% in 2011[v], after growing 3.2% in 2010. (Data reported for 2009 showed a 2.8% decline over 2008). Data from the 2012 survey also confirms that equipment leasing and finance in Canada is experiencing a strong recovery, and that penetration and origination volumes are returning to pre-recession levels. Canada's equipment leasing and finance industry totaled $45.2 billion in 2011. During the same period, industry transactions in the U.S. totaled $628 billion.

All G7 nations saw a decline in lease and finance assets, as well as in the penetration of leasing and finance as a percentage of capital spending on equipment and software, through the end of 2010. CFLA confirmed 15% growth in Canada's 2011 equipment-finance originations[vi], but a post-credit-crisis economy began to take root in 2012, and some economic slowing is occurring[vii]. Three years of economic recovery is now accompanied by a degree of uncertainty, and caution remains a common theme in economic forecasts for Canada.

Size, Organization and Government

Canada is geographically huge, second in world size only to Russia. But the nation is sparsely peopled, supporting a total population of just over 34 million, roughly the population of California. An estimated 75% of Canadians live within 100 miles of the U.S. border.

Canada is geographically divided into five regions, each of which has cultural and economic distinctions. The regions are:

- The Atlantic Provinces (known for fishing, farming and forestry)
- Central Canada (manufacturing, knowledge-based industry)
- The Prairie Provinces (mining, oil and gas, agriculture)
- The West Coast (shipping, tourism), and
- The Northern Territories (mining, oil and gas).

Politically and geographically, Canada is further divided into 10 provinces and three territories. Generally, provincial and/or territorial governments set rules regarding property and civil rights, while the federal government determines policies addressing national issues.

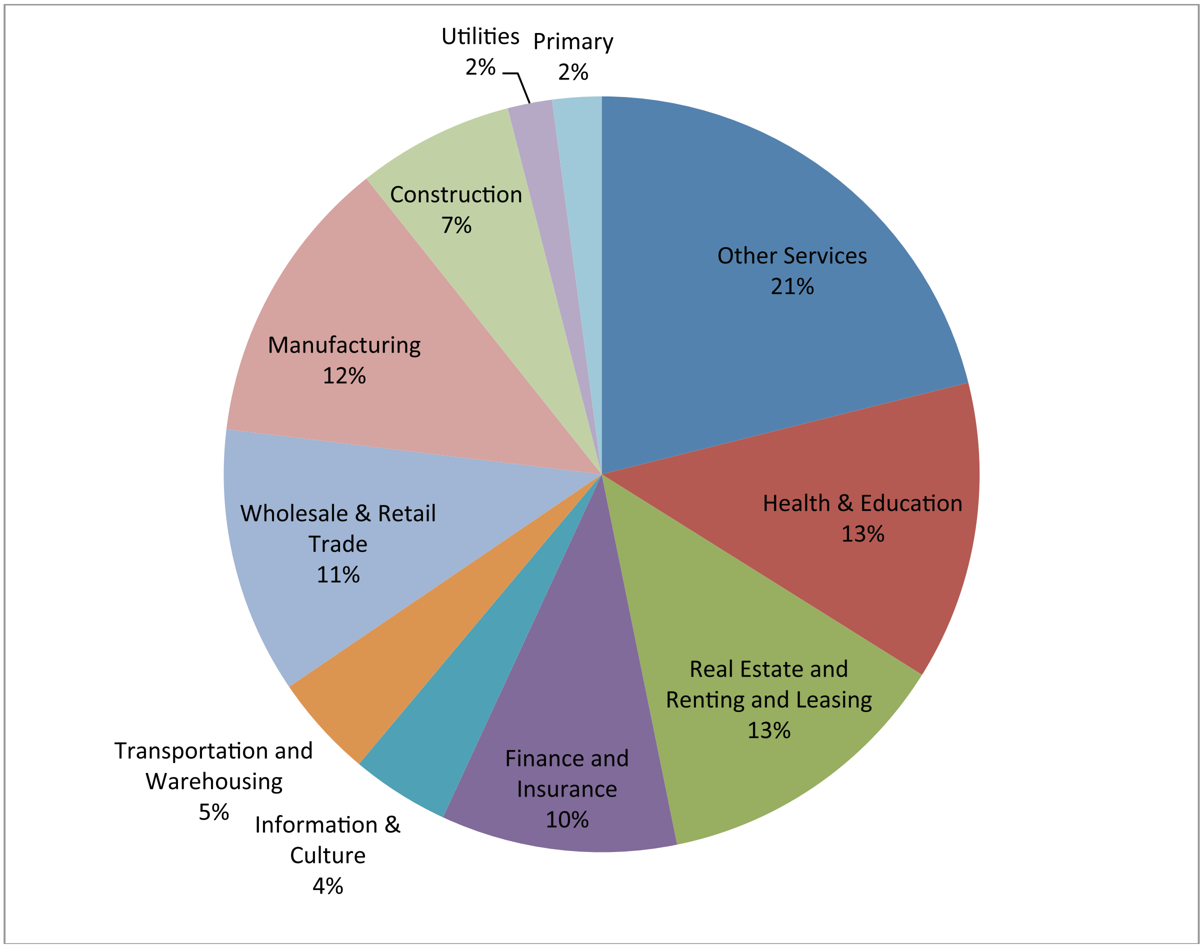
Unlike the U.S., Canada has not adopted uniform business procedures and codes for the secured-lending business. The laws governing the equipment finance industry tend to be provincial. The most important exception is insolvency law, which is a federal matter. Owing to this separation of powers, companies must always be cognizant of where business is being transacted to ensure that the transaction is in compliance with the appropriate provincial laws. Although lack of a unified code may seem daunting, many provinces have adopted substantially similar provisions with respect to particular matters. The exception to this rule, as is the case in several other aspects of Canadian leasing, is the Province of Quebec.

Canada's "founding fathers" knew that French Canadians would play a special role and that special requirements that would arise as a result. Thus, substantially different laws and procedures were established for Quebec in comparison to the rest of Canada. Where appropriate, additional commentary is provided in this report with respect to Quebec and its laws and customs.

Canada's provinces and territories are listed below roughly in order of their economic importance and equipment leasing and finance potential.

Ontario (Central Canada) is the economic engine of Canada. With a provincial GDP nearly twice that of the second largest provincial GDP, Quebec, Ontario produces more than 60% of Canadian goods produced for export. Toronto serves as financial hub of both Ontario and Canada. Most U.S. leasing and finance companies entering Canada choose to locate in or near Toronto. U.S. based firms who have done so include Wells Fargo, CIT, CSI, Dell Financial Services, Key Equipment Finance, and Bank of America.

Figure 2: Structure of Ontario's Economy, 2011, Percent of Nominal GDP



Source: Statistics Canada and Ontario Ministry of Finance

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Quebecois (keb-eh-KWA) voters went to the polls in September, 2012 and elected a new minority government. The Parti Quebecois advocates national sovereignty for the province and secession from Canada. The party's election may lead to another referendum in Quebec, although probably not for some time. It remains to be seen what impact the change will ultimately produce, but it is vital that new entrants understand this segment of the market and its potential effects on key economic drivers.

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Nova Scotia, Prince Edward Island, New Brunswick, Newfoundland and Labrador (The Atlantic Region) are collectively known as the "Maritimes." Historically, the Maritime Provinces have been Canada's weakest economies. But recently, parts of the region have become major oil and gas producers, bringing a welcome boost to the region's GDP.

★Canada's First Nations (Aboriginal) Population★

Canada's diverse First Nations population has a strong political and social voice. The terms aboriginal and first nations are used to identify indigenous populations who were living in Canada when the first European settlers arrived. Numerous reserves in Canada accommodate First Nations citizens who've chosen to remain full-time residents. These individuals receive certain treaty benefits, and their regions possess distinct legal nuances. First Nations people represent a significant percentage of local community populations in some areas, and many reserves sit atop significant mineral wealth. Mining companies are working to expand their privileges on these reserves, but the territorial rights of First Nations must be respected. Permission from reserves and/or reserve residents must be obtained before any trespassing or recovery of assets occurs on First Nations land.

Influences on the Equipment Finance Business Environment

Players: The Canadian equipment finance market is mature, but its players have changed. The catalysts: the global credit crisis and subsequent global economic downturn. Prior to the downturn, the industry enjoyed a market penetration rate consistently above 20%. Asset values peaked in 2008 at $53.8 billion ($42.3 billion in equipment and $11.5 billion in commercial fleet). But the most recent data from CFLA shows that Canada's lease penetration rate has now recovered to pre-recession levels. The World Leasing Yearbook cites Canada as the 9th-largest leasing market in the world. What the Canadian market might lack in size, however, it makes up in activity: acquisitions of independents by Canadian banks, additional consolidation of lessors and brokers, and new market entries have all occurred within the last three to four years, causing shifts in market share and movement of executive talent. Figure 1 illustrates changes in Canada's machinery and equipment investment by area over the last three years.

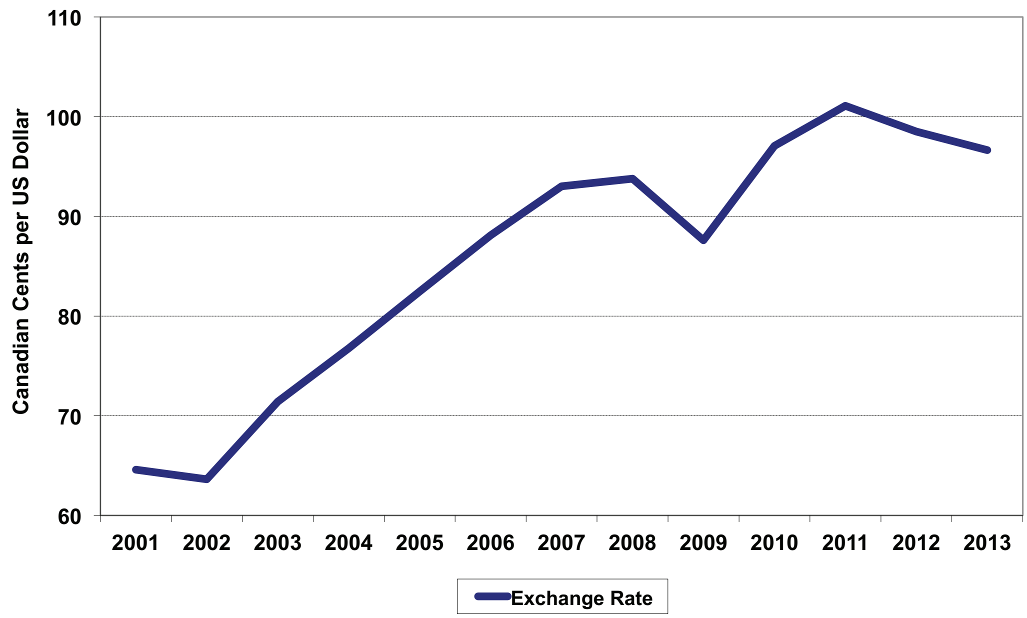
Fig. 3: Private and Public Machinery & Equipment Investment by Area

Area	2012	2011	2010	% 11-12
Newfoundland & Labrador	1,875	1,537	1,384	22.0%
Prince Edward Island	421	409	292	2.9%
Nova Scotia	2,155	2,179	2,102	-1.1%
New Brunswick	2,144	2,143	2,096	0.1%
Quebec	20,949	20,077	18,887	4.3%
Ontario	42,503	43,104	38,382	-1.4%
Manitoba	3,636	3,626	3,179	0.3%
Saskatchewan	5,933	5,306	4,587	11.8%
Alberta	19,720	18,930	20,316	4.2%
British Columbia	12,444	12,230	11,297	1.8%
Canada Overall	**112,418**	**110,063**	**103,010**	**2.1%**

Source: Statistics Canada, 2011 Private and Public Investment Intentions

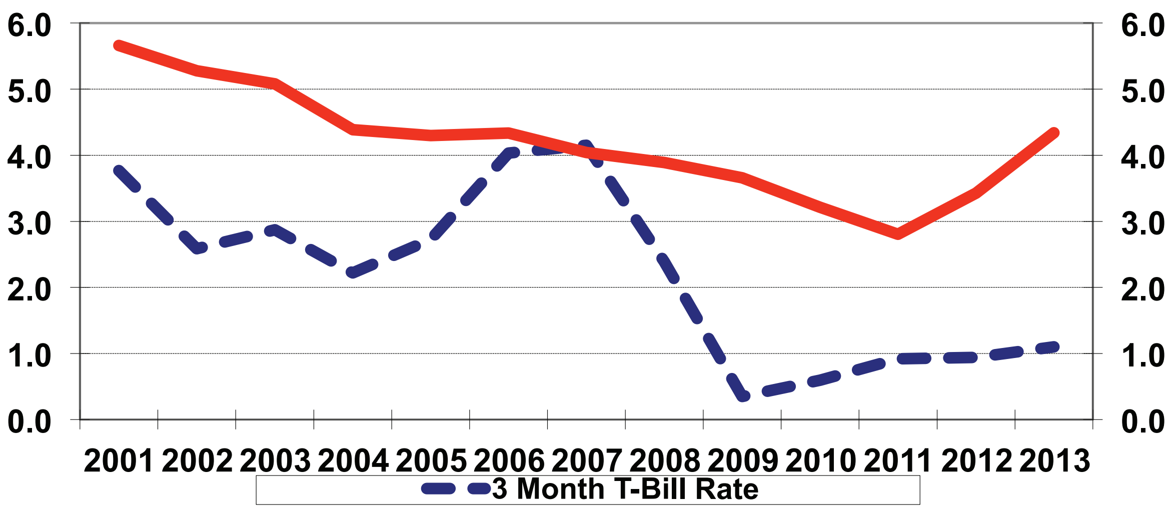
The Canadian dollar: Listed at approximately $1.02 U.S. as of September 10, 2012, Canada's currency has climbed significantly in recent years, affecting corporate earnings. Firms entering the market will want to study past and potential effects of Canadian dollar fluctuation, realizing that changes will affect the relative value of income that may later be added to U.S. financial statements. For U.S. leasing and finance firms operating in Canada, a weaker Canadian dollar would be both a curse and a blessing. Canadian earnings would be subject to a reduction when converted to U.S. dollars, but a stronger U.S. dollar would give U.S. companies an advantage when contemplating acquisitions or additional investment in Canada. The impact of a low Canadian dollar on repatriated income can be mitigated by a currency-hedging strategy.

Figure 4: Value of the Canadian Dollar, 1989-2009



(Data as at December 31, 2009); Somerville, Robyn Center for Spatial Economics, 2012)[viii] The chart showing the massive change in the value of the Canadian dollar over the last two decades needs to be inserted back in – it is a very critical warning to the magnitude of loss or gain that could occur. Chart 4: Canadian Dollar Value Change (Centre for Spatial Economics, 2011 (Based on Member Provided

Figure 5: Canadian Interest Rates



Centre for Spatial Economics, 2011 (Based on Member Provided Data as at December 31, 2011)

Low short- and long-term interest rates: Low short and long-term interest rates have started to diverge in 2012 and global uncertainty continues to make future interest rate direction difficult to predict. The Governor of the Bank of Canada, Mark Carney, continues to state publicly that Canada may need to increase interest rates to slow growth in the Canadian economy and reduce the risk of inflation.[ix]

Canadian lease and finance portfolios: Both perform differently from those in the U.S. markets. Canadian entrepreneurs are more cautious than American entrepreneurs, and this is reflected in delinquency and default performances. A U.S. company's credit policy, and the tools it uses to make credit determinations, may require adjustment as knowledge and understanding of Canada's regional and industry credit performances are gained.

Commercial Lending Trends

PayNet is a leading provider of credit risk management tools and data in the commercial lending industry in Canada and the U.S. A comparison of Canadian and U.S. data, as collected by PayNet, provides unique insight into differences between the two markets. William "Bill" Phelan, President of PayNet, Inc. and a member of ELFA, was interviewed for this report and made the following observations:

"When we (PayNet) entered Canada in 2005, we did not know what the data would tell us. Ultimately, we learned that Canadian commercial lending activity performs differently than in the U.S. We found that, from 2005 through early 2012, lending demand in Canada contributed to real capital formation, while in the United States, a net decline in capital formation occurred during the cycle that included the most recent recession. Canada's performance is an indication of the strength, resiliency and consistency of the Canadian economy. The conclusion can be drawn that the U.S. tends to be more of a boom and bust economy, while the Canadian economy shows more stability."

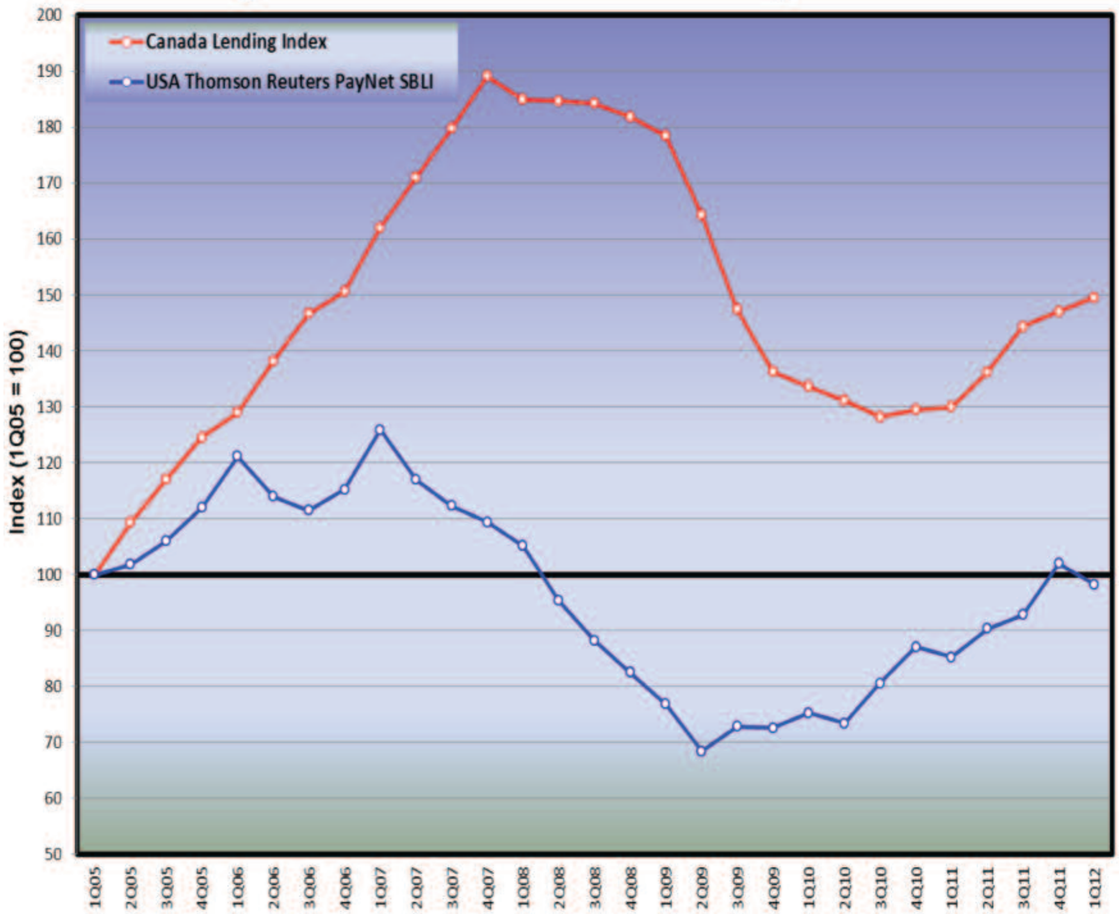
Figure 6 compares PayNet's Canadian Lending Index with the USA Thomson Reuters PayNet SBLI (Small Business Lending Index) from 2005 through the first quarter of 2012. The index measures demand for lending, and how accumulated use of borrowing contributes to capital formation.

As seen in Fig. 6, Canada experienced a 28% increase in capital formation from 2005 to 2012. During the same period, the U.S. did not add real capital formation. Capital formation can be thought of as the creation of a stock of capital, similar to filling a warehouse with goods for sale. Over time, the warehouse can run out of inventory or add to its inventory. Capital formation is a critical indicator of an economy's ability to provide the capital needed to fund growth. Thus, the Canadian commercial lending market not only demonstrated an ability to sustain itself through a tough economy; it showed greater strength and resilience than its counterpart in the U.S.

Comparative Credit Default Rates

Paynet also tracks credit default rates in Canada. Said Phelan, "In Canada we saw default rates that were significantly lower than the United States. In Canada, the default rate peaked at 3.75%. The corresponding peak in the United States was 6.5%. This is a clear indication of the stability and strength of the Canadian economy, and the relative weakness shown by the U.S. economy over this time frame. It was not that U.S. lenders executed poor credit decisions, but more that the economic weakness created a much harsher recovery capacity for U.S. lenders on defaulted transactions."

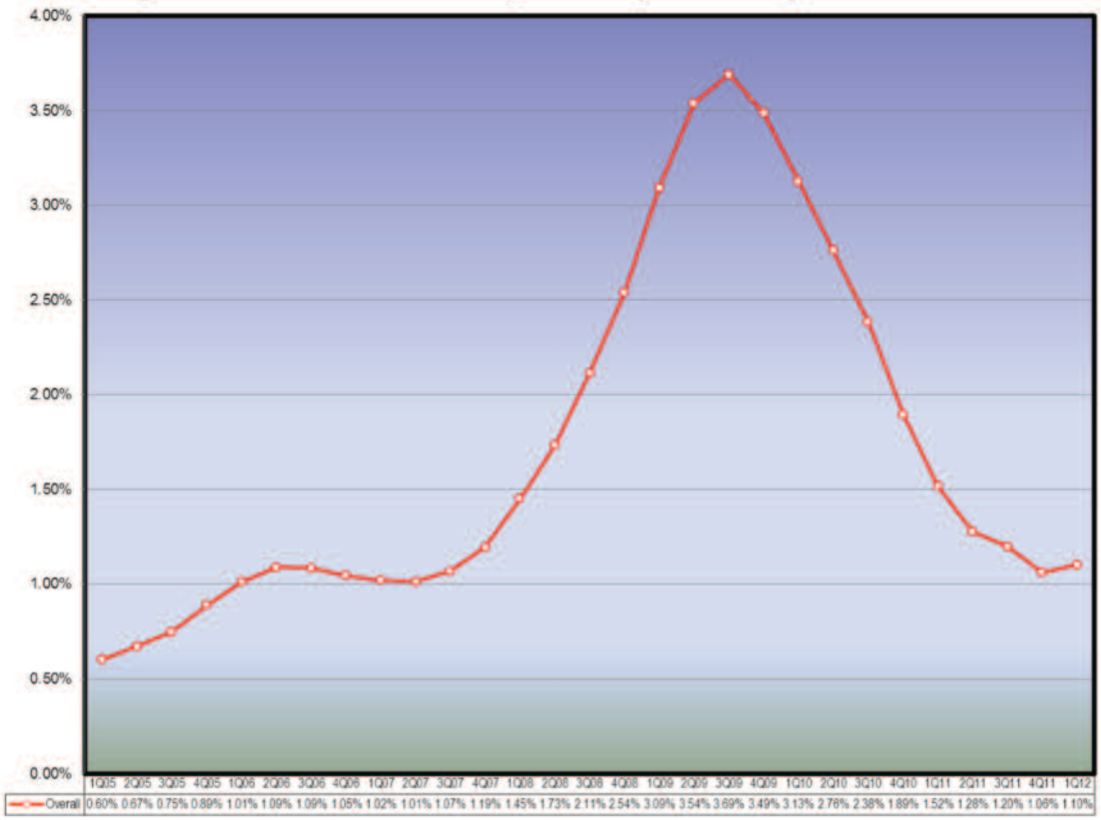
Fig. 6: Canadian and U.S. Business Lending Indices



Sources: Paynet, Thomson Reuters PayNet SBLI

Figure 7 illustrates changes in the default rate on Canadian commercial lending performed during the credit crisis and subsequent global recession.

Fig.7: Canadian Default Rate by Quarter (Annualized), 1Q05 – 1Q12



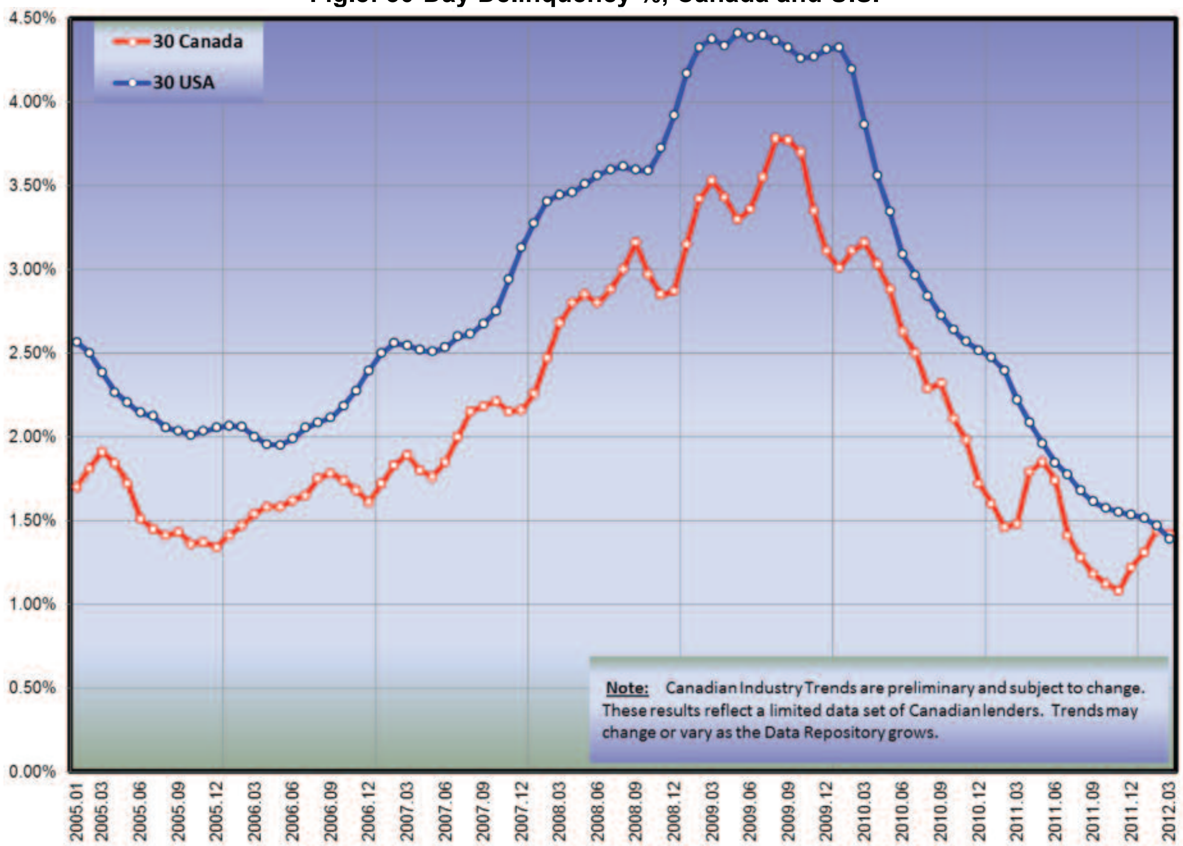
Source: PayNet

Comparative Delinquency Performance

Canadian 30-day delinquency rates consistently fall below those of the U.S. Figure 4 shows the performance of 30-day delinquencies in both Canada and the U.S. from 2005 to 2012. The data supports a key difference relating to the acceptance of Automated Clearing House (ACH), known in Canada as Pre-Authorized Payment Plan (PAPP), as the primary method of payment on lease and loan portfolios. Most Canadian lessors in the small and mid-ticket environments have a vast majority of customers who pay electronically. This is a distinct difference between the two countries and should be taken into account in both Canadian credit approvals and credit conditions.

Interviews with Canadian players indicate that the high percentage of electronic payments also translates into smaller staffing requirements for 30-day collections, and virtually no staffing requirement for preparing and mailing customer invoices. This contributes to lower operating costs and greater servicing efficiencies in Canada, but U.S. lessors earn more income from late fees on invoiced customers. Not surprisingly, Canadian lessors see greater benefit to having few 30-day collection issues than any gain in fee income that could stem from invoicing.

Fig.8: 30-Day Delinquency %, Canada and U.S.



Source: PayNet

Canadian Credit Decisioning

Predictive credit models in Canada use the same drivers of risk that are used in the U.S. But PayNet's Phelan says Canadian appetite for risk, along with the historical performance of risk drivers, are unlike any other. Thus it is critical to recognize that a U.S. credit scoring model will not yield the same results in Canada. Credit requirements, decisioning and pricing should be set by region, province and industry, translating to a customized Canadian credit score card.

"Our Canadian portfolio performed better than U.S. originations, and we attribute part of [this] to our need to scrutinize each credit decision more closely," said one U.S. bank lessor operating in Canada. "We could not use our [U.S.] scoring model, [but] we benefited from Canada's much lower threshold for financial statement requirements. In Canada it is acceptable to request financial statements at $30,000, and this gave us the ability to see more information than we do in the U.S. Application-only business in the U.S. requires us to decision much larger transactions on much less information than we can get in Canada."

Origination Channels, Transaction Types, and Credit

CFLA annually surveys Canada's largest equipment lessors and asks a series of broad questions about originations. But the number of firms reporting has been small, and year-over-year participation is inconsistent. The data should be considered with these limitations in mind.

Figure 5 shows a decline in captive origination and this most likely relates to the credit crisis and the loss of securitization as a source of financing for these entities. A variety of opinions exists regarding credit and pricing. Most "A" credit market players interviewed agreed that pricing was tighter in Canada likely due to the presence of most of the Canadian banks and the limited number of transactions in this space. In transactions of lower credit quality, pricing was similar to that in the U.S.

Fig. 9: Canadian Originations by Channel

Channel	2010	2009	2008	2007	2006
Direct	64%	63%	64%	50%	53%
Vendor	20%	22%	14%	4%	19%
Captive	14%	12%	18%	42%	22%
Broker	3%	3%	4%	4%	5%
Approval %, All Channels	70%	66%	74%	76%	83%

Source: Centre for Spatial Economics

Average transaction size in Canada is usually smaller than in the U.S., owing to Canada's smaller economy, which creates fewer large transactions and more, smaller deals. Interestingly, operating leases are a minor product. But this may stem from certain regulatory conditions discussed later. Executives interviewed indicated that the use of operating leases is generally limited to specialized markets and very sophisticated lessees. Equipment markets frequently requesting operating leases include Materials-Handling, Construction and Transportation. Figure 6 shows transaction types at a glance from 2006 through 2010.

Figure 7 summarizes Canadian funding activity by equipment type. Percentages fluctuate greatly in some categories, partly due to inconsistencies among survey participants. The number of participants is small, but most have large portfolios. Thus, if a large captive representing one equipment type fails to repeat its participation in successive years, percentages in that equipment category can be affected.

Fig. 10: Transaction Types

Transaction Type	2010	2009	2008	2007	2006
Loans	63%	49%	56%	55%	52%
Leases	37%	51%	44%	45%	48%
-Operating	7%	9%	13%	9%	5%
-Capital	30%	42%	31%	36%	43%

Source: Centre for Spatial Economics

Fig. 11: Originations by Equipment Type

Equipment Type	2009	2008	2007	2006
Total Finance Assets ($millions)	$22,800	$19,400	$18,600	$17,100
Hotels, Restaurants, Apartments	8%	9%	9%	0%
Construction	17%	18%	18%	1%
Automotive	22%	27%	29%	26%
Trucks	12%	14%	15%	21%
Passenger	4%	6%	7%	0%
Trailers	4%	5%	5%	4%
Buses	1%	2%	1%	1%
Office Equipment	6%	6%	5%	15%
Aircraft and Related	8%	8%	7%	2%
Mining and Petroleum	6%	4%	4%	1%
Manufacturing and Processing	6%	8%	9%	4%
Materials Handling	4%	3%	2%	5%
Computers (hardware and Software)	3%	3%	2%	2%
Medical, Health Services	3%	2%	2%	0%
Agricultural	2%	1%	1%	3%
Railway Rolling Stock	2%	1%	1%	1%
Forestry	2%	2%	3%	9%
Store Furniture, Fixtures, Equipment	2%	2%	2%	12%
Telecommunications	1%	1%	0%	1%
Office Furniture, Fixtures	0%	0%	0%	1%
Water Vessels	0%	0%	0%	1%
Other	13%	5%	6%	13%

Source: Centre for Spatial Economics

Equipment types vary, based on region and specific drivers to each region's economy. Types of lease pursued, credit-approval percentages and origination channels are all similar to the United States. A full analysis of U.S. and Canadian data is outside the scope of this report but could be undertaken by readers with access to the ELFA annual survey results. But again, caution should be used when considering CLFA data, as it is derived from a small number of contributors.

Industry Participants

The Canadian market includes independents, bank-owned firms, credit unions and captive finance companies. Many U.S. firms operate there, as do firms that are 100% Canadian-owned. CFLA represents both vehicle- and equipment-finance firms and service providers, and has grown from 61 members in 1993 to more than 200 in 2012. The association mirrors much of the mandate and direction of the Equipment Finance and Leasing Association (ELFA). Many U.S. ELFA members say they have found it helpful to also belong to CFLA, as it provides insights into unique challenges of the Canadian market.

A Word About Bank Regulation

In Canada banks operate under federal legislation called the *Bank Act* (the "Bank Act").[x] First passed in 1871, the Bank Act is reviewed every five years to ensure that it is not impeding global competitiveness or stability of banks. There are three types of banks in Canada, referred to as Schedule I, II, and III banks. All are regulated and monitored by the Office of the Superintendent of Finance Institutions (OFSI), but each Schedule type is permitted a different range of activity. Whether a finance company entering Canada is subject to the Bank Act will depend on its domestic structure. But from a leasing perspective, the most significant impact of the law is that Canadian banks and U.S. banks subject to the Bank Act are restricted in the residual position they may take. Banks are limited to a 25% residual in any one transaction, and a total residual exposure of 10% of their entire portfolio. Banks falling under the Bank Act are also prohibited from leasing automobiles and trucks under 21 tonnes on a load-capacity basis.

Domestic (Canadian) Banks

The World Economic Forum has named Canada as having the strongest banking system in the world for four consecutive years[xi]. There are currently 24 domestic banks in Canada, but the majority of banking market share is held by six major Canadian Banks.[xii] These six banks are also are ranked among the 25 strongest banks in the world with four of the six in the top 10 (Pasternak, 2012).[xiii] This gives these institutions tremendous power in domestic and foreign economies.

Within Canada, the major banks have a dominant position in all aspects of commercial and consumer banking and as such there are limited avenues to produce additional growth in domestic market share. Prior to the credit crisis, domestic banks generally offered leasing as a product to their existing customers. Until recently, a few of the banks had a dedicated sales force focused on soliciting equipment manufacturers and dealers for business. It appears the credit crisis has acted as a catalyst for change with several banks acquiring independent lessors and brokers and becoming more active in the equipment leasing and financing market.

Major Canadian banks have acquired the largest independent lessors, changing the landscape of the Canadian market considerably. Independent lessors provide the banks with a different style of origination that has provided enhanced penetration. The banks now can leverage their advantage of pricing and liquidity into market traditionally dominated by independents. It is too early to tell how this change will impact the rebuilding of the independent lease and finance portion of the market.

In addition to being active in originating finance transactions, these Canadian Banks are at times providers of financing to independent and captive leasing companies. The major banks may provide debt through a syndicate or provide access to securitization and other financing sources through their capital markets entities.

Fig.12: Domestic Canadian Bank Acquisitions, 2009-2012

Bank	Lessor Acquisitions	Broker Acquisitions
Royal Bank of Canada	MCAP Leasing, ABN Amro	
Canadian Western Bank	National Leasing Group	Financiere Global
Scotia Bank	Irwin Commercial Credit	Proficom
Toronto Dominion Bank	Capital Underwriters	
Bank of Montreal		
CIBC	CIT Business Credit (JV with CIBC)	
National Bank	Sold Alter Moneta Interest to Bear Stearns	

Source: The Alta Group Canada

U.S. Bank Lessors Operating In Canada

Canada has been home to several multinational lessors who have been successful in the market for many years. The list of long-term participants includes the five largest U.S. bank leasing companies[xiv]. Bank of America Leasing, Wells Fargo, CIT Group, Key Equipment Finance, and PNC Equipment Finance are examples of U.S. bank affiliates operating equipment leasing and finance businesses in Canada. All have operated in Canada for a number of years and succeeded in leveraging U.S. business relationships into Canadian market share gains.

> ***"Our entry into Canada started when our U.S. leasing customers needed to finance equipment being used in Canada. Initially, we accommodated these as one-off requests, but volume grew. It got to a point where we were not meeting customer expectations for service, so we established Canadian operations. Subsequently, our vendor business started to see Canadian activity, and this created the need to hire a "feet on the street" sales force." —*** *A U.S. bank affiliate executive*

Credit Unions

Credit Unions operate regionally in Canada, but recent revisions to the Bank Act allow for creation of a Federal Credit Union. There is considerable activity of credit unions from one province to the next. In British Columba, Westminster Savings Credit Union (WSCU) is active in the leasing industry and acquired an independent lessor (Mercado) prior to the credit crisis. Concentra Financial provides financial solutions to credit unions, including leasing, thereby enabling smaller credit unions to offer leasing to their customers without requiring the full infrastructure of a leasing operation. Credit unions are often located in rural communities, successful, and a key part of the community. Their activity within the leasing industry continues to grow.

Captives

The captive market is an excellent example of how the globalization of markets has required finance companies to perfect the system and requirements to enter and sustain financing businesses in another country. Among captives operating in Canada are five of the largest: John Deere Financial, IBM Global Finance, Caterpillar, CNH Capital and Volvo Financial. The list of U.S. based captives operating in Canada is long as virtually all global manufacturers have determined they need to provide customers with financing in all countries they sell. All long term players in the Canadian market and top captives have achieved success in the Canadian market.

Independents

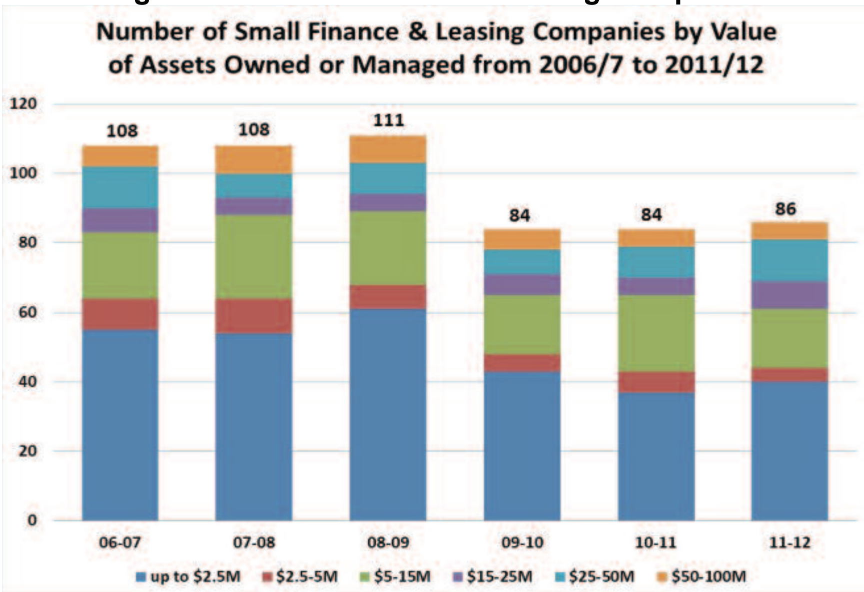
The independent lessor community has seen considerable change due to consolidation. The size and number of independent lessors has dropped along with the corresponding market share. Prior to bank acquisitions, Irwin Commercial Finance, National Leasing Group and MCAP Leasing were all significant shareholders in the small and medium ticket markets. These three firms had a strong national sales force that solicited business directly from equipment manufacturers and dealers. The acquisition of their sales forces by the banks has changed the competitive landscape in Canada and increased price competition in highly desirable sectors (materials handling, medical, dental etc.) at the expense of independents.

The CFLA recently reported on the change in the number and size of small finance companies, many of which are independents:

> ***"Change in the industry can be clearly seen in the impact on the number of small finance and leasing companies in Canada (members of CFLA)[xv]. In the 2009/10 membership year, the number of small company members dropped by nearly a quarter, and has not since recovered. The distribution of companies by size was remarkably stable from 2006 to 2010. In the last membership year (2011/12), however, the proportion of companies with under $15 million in assets fell to 71% from about 79% in each of the previous five years. Scale and size are increasingly important for success in the post-crisis economy, and this this is also evident among larger companies in Canada, at which a series of mergers and acquisitions have taken place over the last couple of years. Securing a stable long-term funding partner appears to be a significant motivating factor behind much of this activity.[xvi]"***

Figure 13 shows the decline in the number and size of smaller leasing firms. The majority of firms represented in this chart are independents.

Figure 13: Small Finance & Leasing Companies



Source: Canadian Finance and Leasing Association

The independent market experienced the return of a major industry player in April 2010 when Steven K. Hudson announced his desire to re-enter the North American equipment and finance industry with the acquisition of an equity stake in Element Financial Corporation (Element). Hudson previously built the second largest independent finance company in the world[xvii] in the 1990's. That firm, Newcourt Credit Corporation (Newcourt)), acquired numerous leasing and finance companies over several years culminating in the sale of the business for $2.4 Billion in 1998[xviii].

Hudson is now CEO of Element Financial and has successfully raised in excess of $200 million to fund acquisitions of finance companies. Element has since become publicly traded in Canada (Toronto Stock Exchange Listing – EFN) and has completed the acquisition of Alter Moneta and fleet lessor TLS Financial. Element has successfully become the largest independent lessor in Canada in a short period of time. All indications are that additional acquisitions are planned, but with the domestic Canadian market containing few qualifying targets, Element is expected to become active in the U.S. market. There has also been limited activity by U.S- based independent equipment lessors into the Canadian market. Some have chosen to fund demand from U.S.-based lessees, while others follow vendor programs.

Figure 14: Independent Lessor Merger and Acquisition Activity

Independent	Acquisitions	Previous Acquisition
Element Financial	TLS Lease Management (Fleet Lessor formerly known as Transport Action)	Alter Moneta
Bennington Financial/Equirex	Bodkin Leasing (Lessor)	Kempenfelt Leasing
NexCap	Little Bros. Trailer Leasing	
LeaseLink	LeasePlus (Broker)	

Source: The Alta GroupCanada

Funding and Capitalization

Securitization

Finance and leasing companies are finding a strong supply of capital in Canada in all forms. The credit crisis significantly halted securitization as a tool for funding finance companies, but the market is recovering well. In July 2012, CIT successfully funded a $531-million securitization of equipment leases and loans, marking the first time the company had tapped the securitization market in Canada since 2009.

In Canada, equipment assets are roughly 2% of the 2012 total amount of Asset Backed Commercial Paper (ABCP) and Term Asset Backed Securities (ABS). These numbers reflect Canadian activity and do not include Canadian Financing that has been part of U.S. securitizations. Additionally some of the independents acquired by Banks no longer use the securitization market.

The deal costs increased after the credit crisis to reflect costs of additional liquidity provisions and greater transaction costs (e.g., legal, additional ratings). Despite the lower numbers in 2012, there are once again consistent issuances and demand for securitization.

Bulk Funding/Private Securitization

Many of the small and medium sized independent lessors find financing through facilities funded directly or indirectly from life insurance companies, smaller banks and possibly other sources. These facilities are similar to securitizations but have lower transaction costs and higher advance rates than conventional securitizations. These specialized structures also often have better advance rates and better leverage than traditional banks. These facilities have been the cornerstone of funding for many of Canada's independent lessors.

Bank Facilities

Canadian lessors and captives have had modest success negotiating borrowing facilities from Canadian and Foreign Banks operating in Canada. Expectations from providers of these facilities are high – a strong balance sheet and excellent historical performance are usually required to negotiate optimal leverage and pricing.

Insolvency Regime

Canadian insolvency law is both federally and provincially governed. The rules governing secured creditors and enforcement rights absent a bankruptcy are governed by the applicable PPSA (in all provinces except Quebec), whereas bankruptcy is governed by federal law.

PPSA Enforcement

In non-bankruptcy situations, the secured party will realize upon its collateral and will have an option to either sell the collateral to third parties or foreclose on the collateral. In either case, the secured party must send a notice to all third parties who may claim an interest in the collateral, including parties with a prior claim, a subsequent claim, and any guarantors. This notice will set out that these parties have a right to redeem the collateral upon the payment of the outstanding obligations. If no party chooses to redeem the collateral within the periods of time specified under the applicable PPSA (15 days in the Province of Ontario), then the secured party is entitled to sell the collateral pursuant to reasonable procedures to a third party and apply the proceeds from the sale to the indebtedness. Any surplus is paid to the debtor, and the secured party can claim any deficiency as an unsecured creditor.

If a secured party were to use the foreclosure procedure, the secured party would likewise have to send out notices, although in a different form, and the waiting period is slightly longer. In these circumstances, the secured party would retain all of the proceeds from the sale with no requirement to account to the debtor; however, the secured creditor is unable to claim the deficiency against the debtor for the unsecured portion of its claim.

It should be noted that in the processes set out above, there is no requirement to make an application to the court with respect to either the seizure or sale of the collateral; it is only necessary to follow the procedures set out in the PPSA. In fact, in Canada, the concept of "smash and grab" still exists provided that the debtor allows the secured creditor onto its property to seize the goods.

Bankruptcy

Canada has two basic bankruptcy statutes: the *Bankruptcy and Insolvency Act* ("BIA") and the *Companies' Creditors Arrangement Act* ("CCAA"). Each of these regimes allows for the equivalent of a Chapter 11 insolvency, but only the BIA is used for the equivalent of a Chapter 7 insolvency. In cases of a Chapter 11-style reorganization, the CCAA involves larger insolvencies, while the BIA is typically used for smaller insolvencies.

Under the BIA, the debtor may file a "Notice of Intention" whereby it advises each of its creditors that it intends to file a proposal under the BIA and initiates a stay of proceedings against the creditors. This proposal will set out a proposed settlement with each of its creditors. The proposal will be considered accepted if it is approved by two-thirds in dollar amount and 50% in number of each of the classes of creditors. From the date of filing the Notice of Intention to the date that the proposal is either accepted or rejected by the creditors, all creditors are stayed from taking further action against the debtor. The debtor is required to file a proposal within 30 days of the date of its filing the Notice of Intention, but can ask for time extensions up to a combined period of approximately seven months.

Generally speaking, courts allow the time period to file a proposal to be extended by 60 to 90 days prior to entertaining creditors' arguments that the stay be lifted. If, on the other hand, it can be shown that creditors will not support the proposal then the court would be more likely to lift the stay at an earlier time period. For a debtor, the advantage of the BIA as compared to the CCAA is that it is a relatively inexpensive process and can be accomplished quickly.

The CCAA process is governed strictly by the court. This regime allows for greater creativity than the process under the BIA. Courts have been known to allow stay periods under the CCAA to extend well beyond the seven-month limit imposed under the BIA and can compromise a variety of creditor claims in ways not permitted under the BIA. Similar to a U.S. Chapter 11 filing, a creditor with a security interest in inventory may be detrimentally affected by these rules particularly if the liquidation value of the inventory will decrease quickly over time.

One significant concern for leasing companies is the effect of the stay on the payment of lease payments during the restructure period. The CCAA and BIA provided that if the lease is not a finance lease but a lease for the "use" of the equipment, then payments should be made during the restructure. Courts, however, have taken a very narrow view of what constitutes a lease for use of equipment and lessors who had "true" leases have been denied payment. While this is an ongoing issue in the Canadian insolvency courts, it would be best to take a narrow or conservative view when underwriting a Canadian transaction.

Notwithstanding, there is still a significant amount of uncertainty as to what is and is not a "true" lease and caution must be taken. It is safe to say that a lease that is considered a finance lease in the U.S. will also be considered one in Canada. But that which is considered a "true" lease in the U.S. may not be considered a true lease in Canada. The good news is that Canadian restructurings tend to be much quicker than in the U.S., and the period of time for non-payment may be a number of months rather than years. It should be noted that there is no concept of adequate protection rule in Canada. There are also consequences for the allocation of costs if a lease is determined to be a true or finance lease, but this is beyond the scope of this paper.

Collection Issues

As in the U.S., Canada has specific rules when collecting consumer debt and practices that must be followed. There are no such rules when collecting commercial contracts; however, most financial companies follow the same rules as if it were a consumer obligation. One area that lessors must be mindful of is collecting debt on behalf of a third party. Under certain provincial statutes, the collecting of third party debt (whether consumer or commercial) would require the company to be registered as a collection agency under provincial law. This can be problematic when there are vendor programs or securitization, as often, the vendor bills and collects on behalf of the finance company but does not "own" the debt. While there have been no reported cases where a company has been charged for not registering under the Collection Agencies Act and there are reasoned opinions as to why this practice is acceptable, it is a potential concern that parties should be mindful of.

Quebec: Vive le Différence

Because of Quebec's historical ties to France, the province has adopted the *Civil Code*. The Civil Code does not use concepts such as security interest, but instead looks at the ownership relationship with respect to the goods, and has significantly different rules in perfecting or noting one's interest. If one were to take a security interest in a particular piece of equipment, for example, the documentation used in Quebec would not be a security agreement but a *hypothec*.

The hypothec is much like a mortgage on real property. It must be registered in accordance with appropriate law. While a U.S. lawyer may be able to grasp what the law is likely to be in the rest of Canada, this would not necessarily be true for Quebec. Accordingly, it is prudent in all circumstances to check with local counsel *each time a transaction is undertaken in Quebec*. For the leasing industry, this is also problematic. While the actual lease document is not that dissimilar from those which are utilized in the U.S. or in the rest of Canada, the registration process and the protections governed thereunder are different.

There is also a clear distinction in Quebec between a two-party and three-party lease. A two-party lease is one in which the seller of the equipment is also the lessor. A three-party lease is one in which the seller of the equipment sells the equipment to a third-party lessor, who then leases the equipment to the lessee, who has specifically requested the lessor to purchase the equipment. A lessor under a two-party lease is not provided with the same hell-or-high-water protections as a lessor who is subject to a three-party lease. *This is particularly important for a captive finance company that does not set up a separate leasing subsidiary.*

★Language Laws★

A note of caution is due regarding which language is used in a lease. Under Quebec law, the rule is unclear, but if the lease is an *adhesion contract* (a standard form agreement that is not of the nature to be modified), then the agreement must be in French. What constitutes a contract of adhesion is far from precise, but in most business transactions of mid-size to large sales, the contract will not be one of adhesion.

Even so, a Canadian lessee can require a lessor to use French in all documentation and in conducting all business. Most sophisticated Quebec businesses transact the bulk of their operations in English, but government agencies tend to require French documentation. It is therefore not uncommon to request counsel from a Quebec firm to provide both English and French versions of a document, along with an opinion that meaning in both versions is one and the same. Doing so adds to transaction costs and may even cause further confusion for U.S. firms–but the customer will likely be satisfied, and all interests will be protected.

Further, the registration process in Quebec is substantially different than in the rest of Canada. Even in a three-party lease situation, there is a distinction between a master lease and schedules thereunder and a lease that is utilized for single transaction only (often referred to as a "snap lease"). In a master lease situation, the registration must be undertaken prior to the delivery of the first piece of equipment. If the master lease is appropriately registered, all equipment delivered subject to the master lease will be granted priority status. It should be noted that the registration, when undertaken, must set out the goods or type of goods that are going to be subject to the master lease. A snap lease, on the other hand, must be registered within 15 days of the date of execution of the lease. Failure to register within this time frame would result in the registration being null and the lessor being subordinate to a trustee in bankruptcy.

It should also be noted that if the head office of a lessee is in Quebec, registrations may be required for certain types of goods even if the goods are not located in Quebec. In cases where you are dealing with a Quebec company, it would be prudent to review these matters with a Quebec solicitor to determine whether a registration is required in that province.

Employment Matters

Unlike the United States, Canada does not have a concept of "at will employment." Employees cannot be terminated as easily or as inexpensively as in the U.S., and while a European model is not followed, a U.S. company must still be mindful of this potential cost. Employment law is provincially based and cannot be "contracted out of." In essence, an employee under provincial law is entitled to approximately two weeks' severance pay for each year of employment.

An employee who is not terminated for cause can also sue the employer for wrongful dismissal, in which awards of one month's pay per year of service are common. This does not mean you cannot terminate an employee with cause, only that it will be costly to do so. Courts do respect properly drafted employment agreements that are fair and reasonable.

Cause in Canada is narrowly defined. Absent fraud, cause is hard to prove. Being incompetent is not considered cause unless a lengthy and constant review process has been undertaken. Examples exist in which coming to work under the influence of alcohol has not been considered cause. Unions are still relevant in Canada, but less so in the financial sector.

Corporate Taxes

Canada was once a high tax jurisdiction and suffered from capital tax. Over the years, though, Canadian tax rates have dropped significantly and are now below the U.S. equivalent. Taxes are paid at both federal and provincial levels, but not municipally. As of late 2012, the combined federal and provincial tax rates for a company located in the Province of Ontario was 26.5%.[xix]

★Canadian Withholding Tax★

Since January 1, 2008, interest paid by Canadian borrowers to U.S. lenders is not subject to withholding tax if the parties deal at arm's length and the interest is not "participating." The tax changes that took effect in 2008 opened a new market for U.S. lenders that was previously restricted, given the added cost of withholding tax.

The above-noted rule regarding withholding tax does not extend to true or finance leases. It should be emphasized that in determining whether a transaction is a lease or a loan, the form and not the substance of the transaction is determinative. If the transaction is called a lease and there is a nominal purchase option, it is a lease for withholding tax purposes. Simply stated, if a U.S. lessor leases equipment to a Canadian lessee, the Canadian lessee is required to withhold and pay 10%

of the lease payment to the applicable Canadian government taxing authorities. (This is not just on the interest component, but on the entire lease payment.) Accordingly, if a lease payment were to be $1,000, the Canadian lessee would be required to withhold $100 from the payment and remit to the U.S. lessor the remaining $900. From an economic standpoint, this is not an acceptable solution.

The most common method of resolving this withholding tax issue is to require the Canadian lessee to increase the payment that would otherwise be payable by the lessee, such that the amount received by the U.S. lessor would be its anticipated payment. This is called a *gross-up provision*. In a sophisticated or negotiated transaction, generally the gross-up provision requires that if the U.S. lender/lessor was able to file appropriate papers and recover some of the tax paid on its behalf by the Canadian lessee; such amount would be returned to the Canadian lessee. Practically speaking, however, many U.S. companies are not in a position to benefit from these foreign tax credits, and the money is lost from the cycle. Requiring a gross-up in a transaction tends to make a U.S.-based leasing company less competitive in the Canadian market, since other parties can provide a financial solution at a lower cost.

Also unchanged in 2008 were the PE (office) rules (see a more detailed discussion below). Generally, finance companies, banks, and non-banks avoided Canada not only for withholding tax issues, but so they would not become subject to what was perceived as oppressive Canadian tax.

The result of the changes, then, will be more limited than thought at first blush. A U.S. lender can now be competitive on loan transactions, but it still must be careful not to have a PE in Canada, as having a sales force in Canada would likely be indicative of a PE, and the U.S. lender would not be able to market in Canada without risk. With that said, opportunity has opened for U.S. lenders without Canadian operations to finance the Canadian subsidiary of one of its existing U.S clients. This possibility should not be underestimated, as it could allow a U.S. lender to retain a client rather than lose it to a multi-national lender or a Canadian bank. For banks with extant Canadian subsidiaries, it is unlikely that they will experience much change as they continue to run their Canadian business in Canada.

Exceptions to Withholding Tax

There are several exceptions to the withholding-tax rules for leases; following are those that tend to be use in most structured cross-border deals.

Aircraft Exemption

The Income Tax Act of Canada ("ITA")[xx] historically exempted aircrafts from withholding tax, because it was difficult for Canadian airlines to attract sufficient capital for the lease of large commercial aircrafts. This exemption remained in the ITA after changes to withholding tax in 2008. It should be noted, however, if a U.S. lessor enters into a lease with a Canadian lessee, then the lessor will not be able to provide the lessee with a Section 16.1 election under the ITA, which provides the Canadian lessee with the equivalent of a synthetic lease.

Establishing a Canadian Entity

The most common method of avoiding withholding tax is to establish a Canadian entity. It is trite to say that there is no withholding tax when a Canadian lessee pays a Canadian lessor. If the Canadian lessor is owned or controlled by a foreign entity then there may be tax concerns on the repatriation of the profits of the Canadian entity back to the U.S. entity, but the fundamental lease transaction between the Canadian lessor and the Canadian lessee remains free from those particular issues. It is for this reason that most finance companies, when determining the most appropriate strategy for conducting Canadian business, choose a Canadian subsidiary.

Assignment to Canadian Partner

The classic way to avoid withholding tax is to assign the transaction to a Canadian entity. The sale of the transaction does not attract withholding tax, and the originating institution could realize its profit from the transaction. Concerns with this solution are two-fold. First, there must be a Canadian entity that wishes to purchase the transaction, and credit approval must be obtained, usually in advance. Second, the originating institution exposes its client to a Canadian competitor, because these transactions must be on a full-notification basis with respect to the assignment.

Canadian Mainstream Taxes: Cross-Border Loans between U.S. Lenders and Canadian Borrowers

A U.S. lender making a loan to a Canadian borrower will not be subject to Canadian mainstream tax if there is no Canadian connection other than the borrower being a Canadian resident. In this case, the loan should be originated through U.S. sources, and neither the negotiation nor the closing should take place in Canada.

If a U.S. lender has a sales force located in Canada, it will generally be regarded as "carrying on business" in Canada, and accordingly will be subject to mainstream Canadian tax. However, if the U.S. lender is entitled to "treaty" protection and the U.S. lender has not established a PE in Canada, the U.S. lender will not pay Canadian mainstream tax. If a U.S. lender has a PE in Canada and is entitled to "treaty" protection, the U.S. lender would only be subject to tax on the profit attributable to the PE. If a U.S. lender is subject to Canadian tax, then it may be entitled to certain tax credits in the U.S. that attempt to limit taxation on the same income in both countries.

Rules relating to the definitions of "carrying on business" and "PE," as well as rules that determine the availability of treaty protection, are complex, fact driven, and should be looked at with care when lender planning a presence in Canada.

Not surprisingly, it is typical for U.S. lenders to first undertake transactions in Canada without "carrying on business" in Canada. As they become more familiar with the Canadian market, U.S. lenders then consider establishing a Canadian subsidiary or Canadian branch operation.

Lease Accounting: Multiple Frameworks to Consider

Until recently, the accounting for leases in Canada and the U.S. was well aligned, making it relatively easy for a U.S. company interested in offering lease products in Canada to understand the impact that various product features were likely to have on product pricing and demand.

With the exception of specialized accounting requirements set out in U.S. accounting standards relating to sale lease-back transactions and build-to-suit transactions involving real estate and a few minor application differences, the core requirements for classifying, measuring and presenting leases was essentially the same: a single leasing model applied by both lessees and lessors that classified a lease as either an operating lease (off-balance sheet for lessees) or a financing lease (on-balance sheet for lessees), based on a series of well-understood criteria or tests. Canadian lessees even had the option of applying the U.S. leveraged lease accounting model.[xxi]

The rules of the game have changed. For U.S. companies entering the Canadian market, the environment became more complicated in 2011.Two groups of commercial lessees emerged in Canada in 2011: those required to (or who chose to) follow International Financial Reporting Standards (IFRS), and those that would follow the new “made in Canada” Accounting Standards for Private Enterprises (ASPE). All publicly accountable entities (those that have issued or are in the process of issuing public equity or debt instruments, regulated financial institutions, and other entities that hold assets in a fiduciary capacity for others) were required to transition to IFRS in their first fiscal year commencing on or after January 1, 2011. All other profit-oriented entities had the choice of transitioning to IFRS or ASPE as at that date. The old Canadian standards ceased to exist.[xxii]

The IFRS framework for lease accounting is set out in IAS 17, while the ASPE framework (effectively a carryover of the old Canadian model) is set out in ASPE 3065. A third framework relating to the requirements for public sector entity lessees continues to be set out in PSG-2 Leased Tangible Capital Assets.

On the surface, these three frameworks are not that different from one another or from the current U.S. lease accounting framework, for that matter. Each requires that leases transferring “substantially all of the risks and rewards” associated with ownership of the underlying leased asset be treated as a financing lease (e.g. equivalent to a financed purchase), with all other leases treated as operating leases. The criteria provided for making this determination, and the degree to which application guidance relating to the substance of the arrangement comes into play, however, does vary considerably among the frameworks.

Not only is there now a requirement for lessors to understand the requirements and nuances of three separate frameworks; there also is a need to understand which framework applies when developing and pricing product for a particular Canadian lessee or target market. Below is a high-level synopsis of key differences between the three frameworks and the old Canadian framework. Following the synopsis is an overview of the specified standards.

IAS 17 requirements

One difference is that the IAS 17 does not provide for any ‘bright line’ thresholds or percentages in its classification criteria, as opposed to a 75% or 90% test. IAS 17 also introduces a few additional criteria to the classification model intended to ensure that the ‘substance’ of a leasing arrangement is more explicitly considered in the classification process. In addition to describing the four main criteria (transfer of title, bargain purchase, economic life test, and fair value test) in less explicit terms thereby requiring more judgment in application, IAS 17 requires a more holistic assessment of the lease arrangement, including consideration of the following in reaching a conclusion on the appropriate classification of a lease:

- Whether or not the leased asset is specialized in nature;
- The existence of bargain renewal options;
- Who is exposed to residual value gains and losses; and
- Who bears losses associated with early lease termination.

The result is that companies following IFRS should expect to see a few more leases reflected as financing leases; particularly those that previously were explicitly ‘structured’ to achieve off-balance sheet operating lease treatment for the lessee. Examples include automotive fleet leases, large-ticket ‘ABC’ leases[xxiii] and certain technology leases.

ASPE 3065 Requirements

For the most part, the ASPE framework is essentially the same as the old Canadian framework. Guidance previously incorporated in a number of separate Emerging Issues Committee (EIC) interpretations has now been incorporated directly in the standard. It is worth noting, however, that the prior EIC that gave Canadian lessees the option of applying U.S. leveraged lease accounting was not carried forward (i.e. – no more leveraged lease accounting in Canada).

The Canadian accounting standard setting body (CICA) has stated that they are not planning to make substantive changes to the ASPE requirements, with the possible exception of those standards that relate to securitization activity, for a period of time to give private companies time to become familiar with the standards and their application in practice. In the long term it is expected that the CICA will move to harmonize the principles and approach underlying the ASPE standards with those inherent in IFRS. When this will ultimately happen is uncertain.

Public Sector Requirements

The provisions of PSG-2 reflect a combination of "rules" and substance-based criteria. In addition to the standard lease classification criteria common to the current U.S. framework (and former Canadian framework), PSG-2 provides a series of other tests and application criteria in determining whether or not a lease should be accounted for as an off-balance sheet rental arrangement or an on-balance sheet tangible capital asset.

Similar to IFRS, the public sector framework requires a more holistic assessment of the lease arrangement in the context of other contractual arrangements, (i.e. – ancillary services, government financial assistance, restrictions or implied terms relating to the use of the leased asset), the nature of the asset (i.e. – whether specialized or related to the provisions of "essential services") and the expectations / motivations of the parties to the transaction. Guidance and examples are also provided with respect to a series of indicators that suggest that the public sector lessee has assumed the benefits and / or risks of ownership, including consideration of residual risk, operating risk, business risk, construction risk, demand risk, environmental risk, obsolescence risk and insurance risk. Careful consideration of the detailed provisions in the context of the public sector entity's and broader government's mandate is required in drawing a final conclusion.

Changes on the Horizon

Although differences exist in the detailed criteria, each of the existing lease models provides the potential for off-balance sheet operating lease treatment. Big changes are on the horizon, however, with the joint project currently underway to overhaul the IFRS and U.S. lease accounting models.

Under the new models, it is expected that lessees following IFRS or U.S. GAAP will be required to show the impact of virtually all leases (including property leases) on-balance sheet.[xxiv] Although not yet final, the proposed income statement treatment is likely to be even more challenging.

During recent deliberations a tentative decision was reached that would result in an accelerated or "front end loaded" expense recognition pattern for virtually all equipment and finance leases, while property leases are expected, for the most part, to be accounted for on a straight line basis like rental arrangements. It is clear that this will have a significant impact on key performance metrics and ratios, and therefore a company's decision-making process when considering lease product.

As of late 2012, final requirements and expected timing of implementation were unknown. Considerable tension existed between the views of the international accounting standard setting body (IASB) and the U.S. accounting standard setters (FASB) on certain elements of the proposals, particularly those relating to how leases are categorized for purposes of determining the appropriate expense recognition pattern. With the recent announcement by the Securities Exchange Commission (SEC) that it has not yet made any decisions regarding whether, when and how it might adopt IFRS, nor does it have any set time by which it will make any such decisions, there is some risk that the final standard adopted for U.S. accounting purposes will be different from that adopted for IFRS purposes, introducing yet another point of divergence. A re-exposure draft is expected sometime in late 2012, with the final standard(s) expected to be effective no earlier than January 1, 2015.

What does this mean for U.S. companies looking to enter the Canadian market? With the current and expanding divergence in requirements between the many and varied lease accounting frameworks, it has become increasingly important to understand which model applies when selecting target markets, designing lease product, and reviewing financial performance in making final origination and pricing decisions.

U.S. Lenders and Canadian Documents

The good news here is that the basic security or lease agreement used in Canada is substantially similar to the one used in the U.S. The process of amending U.S. documents for use in Canada is often referred to as "Canadianization." This is generally accomplished without re-working substantial provisions of the U.S. document, but instead simply fine-tuning certain provisions so that they can be applied in the Canadian environment.

If the debtor has a presence or collateral in Quebec, the security agreement will need to be further revised for use in that province. Quebec uses a hypothec in order to grant the equivalent of a security interest, but the lease is substantially similar requiring only a few further amendments. The hypothec is similar to the older style debentures in that both the amount of the advance (usually 20-25% above the loan amount to cover costs in the case of insolvency) and a nominal interest rate (again higher than the actual interest rate) must be set out. While it is possible to have a single general security agreement that encompasses both Quebec and the rest of Canada, most lenders have separate documentation for use in Quebec. Also, in certain cases there are special formality rules that must be exercised when executing hypothecs, particularly for syndicated facilities.

In Canadianizing a U.S. credit agreement, the most common changes made to a U.S. credit agreement and general security agreement are as follows:

Interest and Penalties

- ❖ Annualized Interest Rates: In Canada, interest must be set out at an annualized rate. If interest is not set out at an annualized rate, it will be read down to 5%. Accordingly, if the interest rate is set out at 1.5% per month, this must be amended to 18% per annum. Also, all loans must set out the interest rate, otherwise, the rate will be deemed to be 5%. There is however no requirement to set out the implied interest rate in commercial lease transactions.

- ❖ Usury Laws: Canada has no usury statute per se, but overcharging for interest is governed by Section 347 of the *Criminal Code*[xxv] which states that any requirement to charge interest over 60% is a criminal offense. It is unlikely that a traditional lending or lease transaction will run afoul of this particular provision on its face. A credit or lease agreement should contain provisions to reduce the rate if it is held to be in excess of the criminal rate. Drafting the clause can be simple or complex depending on the nature of the agreement. For the purpose of Section 347 of the *Criminal Code*, the courts have defined interest broadly, including all charges and expenses associated with the loan (i.e. fees, fines, penalties, commissions, etc.). A lender must pay special attention, especially if the loan is short-term and there are high fees, as it may inadvertently violate these provisions. Canadian solicitors have long debated the impact of violating these provisions, and the results range from overturning the loan entirely to reading down the rate to 60%. Based on the facts of a particular transaction, a court is entitled to reduce the implied interest to the non-offending 60% without amending other aspects of the transaction demonstrating the equitable nature of Canadian courts as long as there is no criminal intent.

❖ Penalties: The courts in Canada have established that provisions that are "penal" in nature are unenforceable. The law regarding what constitutes a "penalty", and thus renders an interest provision unenforceable, is unclear in agreements where an additional payment above the pre-default interest rate is required upon default. There are numerous cases on this issue, but a consistent and defined result has yet to emerge. If the extra charge is seen simply as compensation for true administrative costs or compensation for increased risk, it is likely to be upheld. If, on the other hand, the charge is more punitive in nature, it would likely be viewed as an unenforceable penalty. Clearly, the greater the amount, the more likely it is to be considered a penalty. Most practitioners consider an increase of two percent to be reasonably safe, although it is not uncommon to see post default increases-much higher. In addition, if the late payment provision requires that a certain percentage of the lease payment be made as a cost for a late payment, Canadian courts tend to refrain from enforcing these provisions. Typically, Canadians have high late payment rates to compensate.

The amount due in the event of default under a lease can also be seen as a penalty. Contract law in Canada is the same as it is in the United States in that the lender/lessor is to be placed in the same position as the lender/lessor would have been had the contract been completed. Accordingly, a lease that provides the full payment of all lease payments to the end of the term be paid on default will be held unenforceable. The most common default provision is a formulation approach of the present value of all payments together with the residual; all discounted using an interest rate that reflects a reasonable reinvestment rate. In the current climate, that discount rate is quite low.

Attorneys/Lawyers and Their Costs

In Canadian documentation, attorneys are referred to as "lawyers" and the legal process for awarding costs in a trial differs from the U.S. In a typical Canadian lawsuit, but subject to the discretion of the court, the losing party is responsible for paying a portion of the winner's costs – this is referred to as "cost following the event." Costs are awarded on two different scales: either pursuant to a "partial indemnity costs" or a "substantial indemnity costs" basis. The former is lower than the latter and rarely does the cost award cover all costs incurred. Often, lease agreements will be amended to incorporate these concepts, the result of which tends to make the parties less litigious. In relation to trial costs it should be noted that jury trials for commercial matters do not exist in Canada. As such, a provision dealing with the waiver of jury trial in a security or lease agreement is meaningless except when litigation is brought outside Canada.

Personal Information Protection and Electronic Documents Act (PIPEDA)

Canada has enacted privacy laws that prohibit the collection of personal information and distribution of said information to third parties without first obtaining the consent of the party who provides this information.[xxvi] This applies only to information acquired from individuals, not corporations. Accordingly, if the leasing activity undertaken in Canada is strictly with corporations, there would be no requirement to comply with local privacy laws. On the other hand, if there are consumer transactions or if the entities with whom the transactions are being done are unincorporated, consent should be obtained. Further, and a more likely situation, if a personal guarantee is being given with respect to a corporation's lease, in this case the guarantor's consent to release information should be obtained. In all cases, it is prudent to develop a privacy policy for this type of information.

It should also be noted that the privacy laws refer not just to the matter of obtaining personal information, but also information with respect to employees of the company. Accordingly, many Canadian corporations have developed personal-information policies which govern the collection of data received from employees as well as their respective health records. It is also becoming quite common in purchasing transactions for purchase documents to include a representation and warranty to the effect that the assignor has complied with all laws including, without limitation, privacy laws.

Default Provisions

There are no unique Canadian issues when determining what constitutes an event of default. However, in reviewing a security or lease agreement, one must keep in mind that references to the Bankruptcy Code and the UCC must be changed to the BIA and the CCAA. Expression with respect to insolvency, liquidation and corporate re-organization have different meanings in Canada. If there are references to affiliate defaults or associate defaults, the governing statutes the parties utilize to define these matters will be based on Canadian-corporate statutes, which may cast a narrower or broader net than under the applicable American statute.

One should be cautious when relying on the "material adverse change" clause as an event of default. Canadian courts are reluctant to enforce a default provision if the only event that gave rise to a lender's right to enforce its security was a material adverse change. Since the credit crisis, there has been a renewed interest in drafting these clauses and they are becoming more specific than in the past. It is clear, however, that if a lease line is established for a client and there is a material adverse change, courts will uphold a lender or lessor not extending further credit to the obligor.

Tax and Lease Payments

Lease payments are subject to sales taxes, both provincial and federal. The federal tax is referred to as the Goods and Services Tax ("GST") and, in essence, it is the same as the Value-Added Tax in Europe. The payer of the tax gets a credit against the GST it has paid on this portion. There is no U.S. equivalent to this tax. Provincial Sales Taxes ("PST") is akin to state taxes. It is the obligation of the lessor to remit these amounts to the government. The rate of the provincial tax payable is based on the jurisdiction of the location of the equipment of the lessee, not the location of the head office of the lessee. Ontario, New Brunswick, Newfoundland and Labrador, and Nova Scotia have adopted a Harmonized Sales Tax ("HST"), which is the combination of the GST and PST into a single value added tax. Note that the HST may differ across these provinces, as each province sets its own PST rates within the HST.

Interest payments do not attract any taxes. The purchase of the assets, however, subject to certain exceptions will. One of the advantages of leasing is that the leasing company in essence allows the obligor to pay the taxes over time.

Interest payments as on loan transactions do not attract HST. The obligor will purchase the assets and pay the vendor the applicable HST which the obligor will then add as part of the purchase price. Most equipment lenders in Canada do not finance the HST, but some do.

The most significant difference between the Canadian and U.S. tax structures is with respect to property and municipal taxes. There are no municipal taxes in Canada at this time, and none are anticipated.

Based on the March 2010 CFLA Tax Update, the following should be noted with respect to the recent GST/HST changes. GST/HST is not payable on the supply of “financial services”. Services considered “arranging for” financial services have also been exempt from GST/HST. The federal Department of Finance announced its intent to amend the definition of “financial service” for GST and HST purposes effective December 14, 2009 to limit the scope of GST/HST exemption for intermediaries providing “arranging for” services.

The proposed changes may reverse long-standing policy in that the amendments to the definition of “financial services” will exclude certain services previously identified by the Canada Revenue Agency (“CRA”) as exempt “arranging for” services, however this is still under review and should not be relied upon without further investigation. As well, according to GST/HST Notice 250, “facilitatory services” will be excluded from “arranging for” services. As a result, as and from December 14, 2009, the supply of a “facilitatory service” will be subject to GST/HST. A facilitatory service is described as “preparatory to an actual or intended financial service.” Facilitatory services include market research, product design, the collection and collation or provision of information and other activities. See the CLFA website for examples which illustrate this new policy.

Currency Issues
While there is no requirement that leases in Canada be denominated in Canadian dollars, a court will not enforce a judgment in a currency other than in Canadian dollars. Accordingly, if a financing is denominated in a currency other than Canadian dollars, it is prudent to provide a specific provision to assist the court in determining the applicable currency conversion which should be used in the event of an enforcement situation.

Guarantees
Most jurisdictions in Canada permit corporations to provide a guarantee to any person and on any basis. As a consequence, guarantees may be provided free of concern regarding preference, settlement, fraudulent conveyances or transfers. Some jurisdictions in Canada continue to maintain concepts of solvency tests for certain related parties at the time the guarantee is provided, but not on an ongoing basis. Thus, there is greater flexibility to provide guarantees in Canada than in the U.S.

UCC/PPSA

The first province to enact a UCC-like system was Ontario, and *The Ontario Act* was used as a model for the legislation in other provinces. In all provinces except Quebec, there is a registration system governed by a PPSA. The following are some of the unique registration and perfection issues in Canada:

All Leases Over One Year Must be Registered Under the PPSA

One of the most common mistakes made by U.S. lessors in Canada is not registering a true lease. The one-year rule is broad and includes extension and renewals, even if not explicitly set out in the lease. Accordingly, only leases that are explicitly less than one year and cannot be renewed need not be registered.

The other common mistake is subleasing. If the lessor leases to a client who then subleases the asset to a third party, the sublease also must be registered if it is greater than one year. Failure to do so may cause the lessor to lose the equipment if the sub-lessee were to become insolvent. If the lessee is in Ontario, the lessor should also note that the asset is inventory in the hands of the lessee, and not equipment and formulation for inventory need be followed.

Jurisdiction of Registration

The PPSA follows the rules that existed under the old UCC 9. The proper province in which to register a financing statement is the province where tangible personal property is located except for mobile goods (see below). Non tangible personal property and mobile goods are registered in the province where the chief executive office is situated. In determining the location of the chief executive office where there is more than one office, special care must be taken. Currently there are proposed amendments to conform the PPSAs across Canada with the UCC so that the debtor's jurisdiction of formation is key for registration purposes, but these have yet to be enacted. The PPSA in the province where the secured party is required to register also governs enforcement procedures and policies. There is no definition as to chief executive office, but typically it is taken to mean where the executives of the company are located. If there is more than one such location, all should be used.

For mobile goods, the province in which the chief executive office of the debtor is situated is the appropriate province for registration. One oddity of the PPSAs is that they generally define "mobile goods," as "goods that are normally used in more than one jurisdiction." Accordingly, laptops and other semi-mobile goods can be problematic. Therefore, the prudent course of action with respect to semi-mobile goods is to register both in the jurisdiction of the location of the collateral and the jurisdiction of the chief executive office of the debtor.

American attorneys may be particularly interested in determining where to register against a Canadian company who has assets in the U.S. under UCC 9(R), the appropriate location for filing would be in the jurisdiction where the chief executive office of the Canadian company is situated, if there exists a proper filing system in such jurisdiction. For all Canadian companies, this system does exist and as such, the filing should occur in the applicable province. However, for tangible property, the proper place for filing under the PPSA is the jurisdiction where the tangible personal property is situated and accordingly, a filing in the U.S. would be required. Since the Canadian company is not registered in the U.S., the applicable jurisdiction for registration would require a filing in Washington, D.C. For tangible personal property situated in the U.S., our advice is to register under the provincial legislation in Canada where the debtor's chief executive office is situated, the state where the tangible property is situated, and Washington, D.C.

An example is illustrative. Assume Lender A enters into a lease with a lessee who is an Ontario company, but with a division in New York state. The lease is for equipment located in New York. Lender A properly registers in Ontario in time under UCC 9(R) to obtain a purchase-money security interest ("PMSI"), but not in time under the PPSA (under the UCC, there is a 20-day window, and under the PPSA, there is a 5-day window). Further, the lessee has a prior-secured creditor, Bank B who has a blanket security over all of the lessee's assets. Lessee becomes insolvent. Under UCC 9(R), Lender A has priority as all steps were taken to obtain the proper PMSI. Under the PPSA, however, Lender A may not have priority and Bank B may try to claim priority under its blanket security. This matter has not yet been litigated; however, it is anticipated that Lender A would prevail, but there may be an interesting argument on behalf of Bank B. Prudently, in such circumstances, it is strongly advised that a waiver be obtained from Bank B.

Debtor Name

Much like the U.S., Canada has very specific rules regarding debtor names. For example, a failure to register the correct debtor name is fatal to a registration. While some provinces have enacted more liberal saving provisions than others, the general rule is that if the name is improperly set out on the financing statement and, as a result, would not be discovered by a search under the correct name, then the registration will be null and void.

What makes this particularly difficult is that the articles of many Canadian corporations provide for both an English name and a French name. Often, the individuals working for a company do not have knowledge of the French name of the company. For this reason, one should always undertake a corporate search to determine the complete and proper registered company name.

Equipment Description

All provinces, with the exception of Ontario, require specific equipment descriptions on the financing statement. The only grey area with respect to registration for these provinces is whether a reference to a lease schedule, rather than a full listing of the equipment, is sufficient. There are various cases with respect to this matter, and this is not settled law. Accordingly, the prudent course of action would be to register in the collateral description area both the lease number, the applicable schedule, and (to the extent possible) the actual equipment subject to the lease. Of course, this could be an administrative nightmare in situations where there are a number of small pieces of equipment being financed, as with a computer system. Generally, our recommendation under these circumstances is to provide a generic description of the equipment so that it can be identified and to list any major components of the system.

Another oddity of the Ontario system (as opposed to the rest of the country) is that there are boxes to check to describe the type of collateral that is being financed. In Ontario, the choices are: consumer goods, accounts, inventory, equipment, and other, as well as a box to indicate whether motor vehicles are included. While Ontario does not require a collateral description, it does require that the correct box be checked.

If you are financing inventory and you check the box marked "equipment", the registration would be invalid. In addition, many parties check the box marked "other" to cover the proceeds from the sale. This is an incorrect (but common) procedure. The problem with checking an incorrect box is that you may receive requests for subordinations from parties owing to their desire to ensure that there is no security interest in property that they intend to finance. Also problematic is if the obligor is entitled to sublease. If they are then, it may not only be equipment in their hands but also inventory and both boxes need to be checked.

It should also be noted that, in Ontario, while there is no requirement to provide a collateral description, there is an opportunity to do so. The rationale behind this is that if a finance company is just taking a security interest in one particular asset and does not wish to receive subordination requests from other parties, it can list the assets, with the result that the security interest would be restricted to the assets listed. One problem that is commonly encountered is a registration with a specific asset listed under the general collateral description and boxes marked, for example, "equipment" and "other". In this situation, there is no certainty that the collateral description refers to the "other" and, as such, there is likelihood that subordination letters would be requested, notwithstanding that the procedure being followed was intended to minimize this.

It should also be noted that, in Canada, as is now the case under Article 9(R) it is possible to take a security interest in an intangible. Accordingly, it is not uncommon for licensors to provide for a security interest in the licence granted to a licensee and for finance companies to likewise take a security interest in the software. Practically speaking, while it is difficult to resell software, it does have some in-place value and it may provide leverage in an insolvency situation. In these particular circumstances, the use of the box marked "other" is appropriate.

Assignment of Accounts Receivable/Purchasing Equipment Finance Contracts
In all provincial PPSAs, there is a requirement to register a financing statement for an absolute assignment of accounts receivable, whether or not such assignment creates a security interest.
For example, if Buyer Bank is purchasing a portfolio from Seller Bank regarding Debtor X, then Buyer Bank is required to register a financing statement against Seller Bank. If Buyer Bank fails to register its financing statement against Seller Bank and Seller Bank was to become insolvent, any amounts owing from Debtor X to Buyer Bank pursuant to the assignment would be subordinate to a trustee in bankruptcy of Seller Bank. While this result may be counterintuitive, it is a critical consideration when purchasing a portfolio.

This rule is often missed when purchasing finance contracts, particularly in vendor relationships where there is an ongoing relationship. This rule remains even where there is a true sale of the receivable and no back up security interest is provided. The purchaser of a receivable must register against the vendor and a failure to do so will render the sale opposable by a trustee in bankruptcy. If originals of the equipment finance contracts are delivered, then perfection can occur by possession and no registration is required.

Government Contracts/The MUSH Sector
As in the U.S., anti-assignment clauses are generally ineffective to prevent the assignment of receivables in Canada. Third party financiers can safely advance money on the security of a contract with an anti-assignment clause.

Under Canadian federal legislation, receivables owed by the federal government cannot be assigned as security unless appropriate notice is given to the government and the government consents to such a transaction. Some provinces have similar legislation covering receivables owed by the provincial government but most are assignable without consent. Accordingly, if an equipment finance agreement is being purchased from a governmental entity, the law governing that entity should be reviewed and complied with.

In Canada, unlike the United States, it is very rare to have fiscal funding out clauses in government contracts. While some federal government contracts do allow for the early termination of the contract, it is generally only provided for if there is a full payout of the contract (utilizing applicable present values). Based on this, there is a very active market for governmental contracts as the credit of these entities is deemed to be the same as the governments, which in Canada are all at least A rated.

The government arena is called the MUSH sector. MUSH stands for Municipalities, Universities, School Boards and Hospitals, almost all of which are funded by the applicable provincial government. Many U.S. lenders apply U.S. rules when credit approving this sector, which causes them to miss out on excellent credit opportunities.

This is particularly problematic in non-notification structures and as such, the credit of the vendor of the contract becomes of primary concern.

Purchase-Money Security Interest ("PMSI")
Much like under UCC 9(R), a creditor can obtain super-priority status if all the appropriate steps are followed to obtain a PMSI. All leases and equipment finance contracts are PMSI contracts and the super-priority status will be obtained if the formalities are followed. In essence, the equipment contract must be executed and perfected within fifteen days of the debtor having possession. The key is that the contract has a sufficient description for the assets to be identified (which may be problematic if the equipment is delivered prior to the schedule being executed) and there is proof of delivery. The best proof of delivery is a bill of lading from third parties, but certificates of acceptance are also utilized (but may be subject to review). Sale leaseback transactions are exempted from PMSI transactions and care must be taken in reviewing purchase orders to ensure that the leasing company is worded as purchaser.

Five Options for Entering Canada

U.S. Funding of Canadian Deals in the U.S.
The easiest way to enter the Canadian market would be to transact business from the U.S. headquarters and not to establish operations in Canada. This strategy would result in the lowest transaction costs and have the least potential legal ramifications, as U.S. law would apply to a particular transaction with the exception of those areas that must be governed pursuant to local law. The factors that drive whether this strategy will work will be marketing concerns, withholding tax concerns, regulatory concerns, and of course the requirements of clients. If transactions can be documented as loans as opposed to leases and there is no requirement to have a sales force in Canada, then this entry point tends to make the most economic sense. As set out below, there are local Canadian legal issues that must continue to be observed. This option is generally used when there are one-off transactions that are presented, and typically this is the first entry point where a finance company learns about the market.

U.S. Formation of a Canadian Subsidiary
This strategy is the most commonly pursued by U.S. companies currently active in Canada. These

firms establish a legal operating entity in Canada and follow through with hiring management and staff to pursue the market. There are numerous issues from an operational standpoint, as set out below. Legal matters are discussed in the following section.

- Main operating issues relating to establishing operations in Canada include:
  - Accounting, Legal and Tax Planning
  - Canadian Treasury and Treasury Management Requirements
  - Determine source of Capital for Canada
  - Establish Deal Management Requirements

- Technology: Service Provider review of Canadian Requirements

- Sales Tax (Harmonized Sales Tax, Goods and Services Tax, Provincial Sales Tax)

- Canadian Accounting Requirements and integration to U.S. Accounting
  - Canadian Data Entry Requirements
  - Canadian Reporting

- Canadian Customer Interfaces

- Canadian Web Presence

- Sales and Business Development

- Documentation
  - Canadian Version of Lease Contract; all documents to fund in Canada must meet Canadian legal requirements (see more in legal below).

- Credit, Collections and Administration Policy
  - Canadian Credit policy will be based on different parameters and data sources.
  - Training on Canadian Products, Tax and Accounting Treatments, Pricing, and permitted activity.
  - Collections Policy will need to reflect permissible action in Canada.
  - Bailiffs, Collection Agencies, Remarketing Partners and other resources will have to be researched and relationships established.

- Portfolio Management: Managing Canadian clients will require training of customer service on new policy and procedure.

- Security Registration Technology (Similar to UCC Direct) and Training.

- Human Resources
  - Compensation: Gain knowledge and understanding of salary and benefit expectations for Canadian positions.

Entrants to Canada need to be advised of key employee rights issues in each province with special emphasis on severance liability.

Co-ventures with an existing Canadian leasing company

U.S. firms with modest volume expectations for Canada may wish to partner with a Canadian lessor that can provide all service and support needed to meet the expectations of Canadian business opportunities sourced by the U.S. finance and leasing company. This has been an effective strategy for some firms seeking to reduce the risk of a complete start-up.

A key issue in this strategy is to establish non-compete and non-circumvent agreements. Appropriate co-venture partners are Canadian companies that are servicing comparable clients but do not operate in the United States. This strategy is more effective if the co-venture can meet service level, pricing, and credit appetite parameters.

For example, the initial creation of Dell Financial was a virtual joint venture between what is now CIT and Dell. Recently CIT sold the entity to Dell.

Servicers

U.S. and Canadian-based servicers exist that can provide complete portfolio servicing in the Canadian market. This is another strategy that reduces the risk of errors and can speed market entry. Servicers have provided a quick start and have all issues discussed in point II above well in hand. The strategy is most effective when the primary driver of entry is to provide a leasing solution in Canada for domestic U.S. clients. If a longer term high volume presence is expected in Canada, U.S. lessors will pursue the creation of its own Canadian management staff. This can be done in addition to the use of a servicer and ultimately replace the servicer. The funding of the transactions being serviced can be arranged by some servicers or provided by the company requiring servicing.

Quasi-Securitization

A variant on establishing a Canadian subsidiary to enter the Canadian market is for a U.S. lender to securitize an existing Canadian portfolio through a cross border loan. If a U.S. finance company desires to have Canadian exposure to a lease or group of leases and they have been originated by a Canadian lessor, then the U.S. bank can develop a loan structure which would accomplish this goal. The U.S. financial institution would lend to the Canadian leasing company and take a first ranking security interest in the lease or pool of leases and enter into specific administrative procedures, such as blocked accounts, to cause the lease payment to be paid to the U.S. financial institution. In essence, this would be a non-recourse loan to the Canadian leasing company or special purpose entity which could be bankruptcy remote. Needless to say this over simplifies the various concerns that arise in these structures (such as insolvency and inter-creditor), but is a bare bones sketch of a possible funding option.

Legal Considerations, Subsidiary Formation

If it is determined that the most appropriate method of conducting operations in Canada is by establishing a corporation or other legal entity, then legal, tax, and other concerns must be considered. Canada has two types of corporations, being what is referred to as a ‘C’ corporation in the United States and an unlimited liability corporation (see below). There is no equivalent to an ‘S’ corporation or a limited liability corporation.

The concerns most commonly raised include jurisdiction of incorporation and the structure of the corporation. A corporation may be incorporated under any provincial jurisdiction or under federal law. Generally, most companies that establish operations in Canada tend to incorporate federally, but there is no compelling reason to do so. Canadian incorporation costs are about the same or lower than in the U.S. and follow much of the same corporate logic. The cost of incorporating and the corporate law statutes tend to be similar throughout the provinces, although the Canadian residency requirements of directors do vary and may be a determining factor when selecting a jurisdiction in which to incorporate. Federal companies require that at least 25% of the directors are resident Canadians; provincial legislation in New Brunswick, Nova Scotia, and British Columbia, have no residency requirements.

The other major choice with respect to incorporation is the use of a vehicle known as an unlimited liability company ("ULC"). The reason for utilizing this structure is that a ULC is viewed from a U.S.-tax perspective as being able to take advantage of the check-the-box system. This allows a flow-through of profits and losses back to the U.S. parent. However, amendments to the Convention between Canada and the U.S. with Respect to Taxes on Income and on Capital (the "Treaty") deny benefits to certain amounts paid by a ULC. A further advantage of the ULC is that there are no Canadian residency requirements for directors. On the other hand, the cost of setting up a ULC and the ongoing maintenance is greater than that of a traditional corporation; however, in recent years those costs have decreased. Therefore, in determining whether it is appropriate to use a ULC, a tax professional should be consulted especially with regard to the denial of Treaty benefits.

Currently, Alberta, British Columbia and Nova Scotia are the only three provinces that allow the use of ULC's. Nova Scotia was the first province to provide for ULC's and as such is the most utilized jurisdiction. In the past number of years the annual filing fees in Nova Scotia have risen substantially making ULC's less economically attractive. In 2005, Alberta introduced legislation providing for ULC's and has established both the incorporation cost and annual fees at a level substantially below that of Nova Scotia. There are certain technical reasons why a Nova Scotia ULC may be preferred, but many companies are utilizing Alberta ULC's. While Alberta requires that 25% of directors of a ULC be Canadian residents, Nova Scotia and British Columbia do not require any directors be Canadian.

How to Finance the Subsidiary – Thin-CAP Rules

Different methods of obtaining financing were discussed in Section 4 above. An additional concern regarding subsidiaries is capitalization. Capitalizing the Canadian subsidiary requires specific tax advice. In order to obtain tax efficiency and to allow the interest on debt to be deductible, entities need to comply with the 'thin cap rules'. In essence, the debt to equity ratio can be no greater than 2 to 1 (as of the writing of this paper).

The thin capitalization rules will be changing effective January 1, 2013. One of the amendments proposed will change the ratio to 1.5 to 1. The impact will be that Canadian subsidiaries will require more equity in order to obtain tax efficiency. The proposed changes will treat these non-deductible interest payments (the portion that exceeds the ratio) as dividends paid by the corporation for withholding tax purposes, resulting in the imposition of a 5%, 15% or 25% withholding tax, depending on the circumstances. The changes also extend the application of the thin capitalization rules to partnerships where one of the partners is a corporation.

One area that was not changed in the recent Canadian federal budget deals with situations where the leverage to the Canadian subsidiary was provided by arm's-length third parties. A common structure utilized is to have the non-Canadian parent of a Canadian subsidiary provide a guarantee of its Canadian subsidiary to either its main creditor or a Canadian national bank and then have that financial institution provide debt to the Canadian subsidiary. The debt provided by the financial institution is not factored into the calculation of the debt/equity ratio for thin capitalization purposes. The interest payable by the subsidiary to the third party finance company would remain deductible. The new rules should have no impact on this structure.

Conclusions

Oh, Canada! So like the United States, yet so distinctively different. Yes, it is possible to have one-off transactions, but to properly establish a Canadian presence, local management is necessary. Pricing, documentation, credit and collections: all possess a Canadian component that should not be ignored. Thoughtful adjustments to practices and procedures used in the U.S. can mean the difference between smooth Canadian transactions and dissatisfied customers who take future business elsewhere. Paths to Canada contain learning curves, and bumps along the way. But like firs in a deep forest, challenges are features of new frontiers–and smart, growing firms know to expect them. In closing, we offer remarks from executives at three U.S.-based equipment leasing and finance firms now doing business in Canada:

❖ *"We found that our Canadian sales force and some management had a very different philosophy and a more laid back and in some ways passive approach. Applying our management style in Canada would probably not have worked."*

❖ *"Canadian Executives understood how to compete and sell against the Canadian Banks and understood some of the product restrictions imposed by the Bank Act and other Canadian market realities. Canadian market knowledge and experience was a necessity"*

❖ *"Canada may only have the 10% of the population but they have the same number of competitors as the U.S. The Canadian Banks operate at a much higher efficiency ratio than the U.S. and their treasury cost is very low. Canadian Executives helped us navigate the competitive environment and accelerated our success."*

Appendix

Canadian Federally Regulated Banks

Domestic Banks
B2B Bank
Bank of Montreal
Bank of Nova Scotia (The)
Bank West
Bridgewater Bank
Canadian Imperial Bank of Commerce
Canadian Tire Bank
Canadian Western Bank
Citizens Bank of Canada
CS Alterna Bank
DirectCash Bank
Dundee Bank of Canada
First Nations Bank of Canada
General Bank of Canada
HomEquity Bank
Jameson Bank
Laurentian Bank of Canada
Manulife Bank of Canada
MonCana Bank of Canada
National Bank of Canada
Pacific & Western Bank of Canada
President's Choice Bank
Royal Bank of Canada
Toronto-Dominion Bank (The)

Foreign Banks
Foreign bank subsidiaries are regulated under the Bank Act. Foreign bank subsidiaries are controlled by eligible foreign institutions.

Amex Bank of Canada
Bank of America Canada (In Voluntary Liquidation)
Bank of China (Canada)
Bank of Tokyo-Mitsubishi UFJ (Canada)
Bank One Canada (In Voluntary Liquidation)
BNP Paribas (Canada)
Citco Bank Canada
Citibank Canada
CTC Bank of Canada

Habib Canadian Bank
HSBC Bank Canada
ICICI Bank Canada
Industrial and Commercial Bank of China (Canada)
ING Bank of Canada
J.P. Morgan Bank Canada
J.P. Morgan Canada (In Liquidation)
Korea Exchange Bank of Canada
Mega International Commercial Bank (Canada)
Shinhan Bank Canada
Société Générale (Canada)
State Bank of India (Canada)
Sumitomo Mitsui Banking Corporation of Canada
UBS Bank (Canada)
Walmart Canada Bank

Foreign Bank Branches (Full Service)

These are foreign banks that have been authorized under the Bank Act to establish branches in Canada to carry on banking business in Canada. The following is the name under which these foreign banks carry on that business in Canada. Generally, these foreign banks may not in Canada accept deposits of less than $150,000.

Allied Irish Banks, plc
Credit Suisse AG, Toronto Branch
Merrill Lynch International Bank Limited
PNC Bank Canada Branch
Union Bank, Canada Branch

Acknowledgements

The authors wish to thank **Loraine D. McIntosh**, a partner at Deloitte for contributions to this report.

Executives currently working for or with employment history at the following firms were interviewed for this report. Their assistance is greatly appreciated.

BAL Global Finance Canada Corporation
Key Equipment Finance
Canadian Finance and Leasing Association
Centre For Spatial Economics
CIT Financial Ltd
CSI Financial
Financial Pacific Leasing
GE Capital
Great American Insurance Company
LeaseTeam Inc.
National Leasing Group
National Bank of Canada
PayNet
Securcor
Wells Fargo Equipment Finance

Additionally, this study was guided by a steering committee of industry volunteers who provided feedback and suggestions throughout the development of the report. Their participation is appreciated. They are: Andrew Kindsvater, Dan Mahoney, Jeff Tuecke, Melisa Carter, Steve LeBarron and Richard D. Gumbrecht - Chairman of the Foundation's Research Committee.

Footnotes

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[xix]Federal rate is 15% as of January 1, 2012, Provincial tax rate is 11.5% as of July 1, 2011
[xx]R.S.C. 1985 (5th Supp.), c.1.
[xxi]EIC 46 – Leveraged Leases requires Canadian lessees to follow the criteria set out in Canadian financial instruments standard (CICA 3861) in assessing whether or not the leveraged lease and related debt financing can be offset. Otherwise, the U.S. requirements for leveraged lease accounting, including disclosure, are to be followed in their entirety if a lessee elects to follow the U.S. leveraged lease model.
[xxii]Note: The requirement to transition to IFRS or ASPE has been delayed for Investment Companies. Until such time as transition is required, Investment Companies will continue to follow the Investment Company accounting provisions set out in the old Canadian framework.
[xxiii]An ABC lease is a lease that provides a series of end-of-term options – e.g. lease renewal, purchase option, return of equipment – that is specifically constructed to enable operating lease treatment, although in many cases it is very likely that the lessee will exercise the option that either extends the term or results in asset ownership.
[xxiv]An option to account for certain short term leases (with a maximum possible lease term including renewal and extension options of 12 months or less) like operating leases is expected.
[xxv]R.S.C. 1985, c.C-46
[xxvi]Personal Information Protection and Electronic Documents Act, S.C. 2000, c.5 ("PIPEDA")

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Jonathan is a partner in the Financial Services Group and chair to the firm's Asset & Equipment Finance Group. His financial services practice focuses on the commercial finance industry with a particular emphasis on innovative cross-border transactions and equipment finance. He has particular expertise assisting US commercial finance companies, both public and private, with establishing operations in Canada providing both legal and practical business advice. His experience also extends to all forms of debt finance including sub-debt, venture financings, convertible debt, tranche b debt and asset-based lending. He is noted in both Lexpert and Best Lawyer as one of Canada's leading lawyers in Equipment and Asset Finance and hold Martindale Hubbell's AV Preeminent Rating. Jonathan's exposure to commercial finance provides him with a unique insight in acting for both debtors and creditors in financial restructuring. His solicitor-focused restructuring practice focuses on strategic planning within an insolvency context. When acting for a creditor, Jonathan provides practical advice on how to maximize returns without exposing the creditor to enhanced liability.

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