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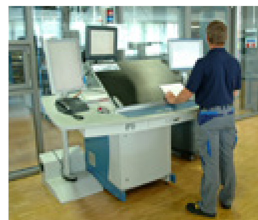
M&A Has Rapidly Changed the Canadian Commercial Equipment Finance Marketplace
By Hugh Swandel
Since the global crisis of 2008, consolidation and change have redefined the major players in the Canadian leasing industry. As with other types of financial services, the leasing industry was trying to understand a situation few had predicted and none could navigate with certainty. Banks and credit unions have gained market share at the expense of independent and foreign lessors. This article explains how those changes occurred and what they may portend.



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Financial covenants are promises by a borrower or lessee to achieve or maintain specific financial targets, often expressed as ratios, such as net worth or total debt levels, or cash flow debt coverage ratios. A survey of banks, independents, and middle-market companies examines whether, in the wake of the Great Recession, financial covenants have become commonplace in equipment finance documentation.

Financial covenants are promises by a borrower or lessee to achieve or maintain specific financial targets, often expressed as ratios such as net worth or total debt levels, or cash flow debt coverage ratios. In 2010, the authors published an article in this journal titled "Financial Covenants: Why They Are Coming Soon to a Lease Near You" (Vol. 28, No. 1, Winter 2010). The article indicated that the addition of financial covenants to equipment lease contracts seemed to be on the rise. One explanation was that credit officers were beginning to wonder why a borrower in a traditional loan arrangement was required to meet financial requirements while a lessee or borrower in an equipment finance transaction was not.

The information on the use of such covenants was anecdotal. The lead paragraph in that article stated:

> The recent economic downturn has shined a light on several weaknesses in equipment lease documentation. One of the most notable has been the lack of a lessor's ability to take action before an actual rent or other "monetary" default occurs. Many lessors have watched helplessly while lessees circle the economic drain, experiencing deteriorating financial conditions that will inevitably lead to bankruptcy.

Our inquiry was into whether financial covenants, which showed signs at least in anecdotal evidence of becoming more popular immediately after the 2008–2009 Great Recession, would become commonplace in equipment finance documentation in the years that followed.

The purpose of this article is to report the results of a survey to determine the extent to which financial covenants are used in equipment leasing contracts. Is their use on the rise? Are they commonplace now? Were they a passing fad? This survey is designed to shed light on their use or lack of use, and the reasons at play in either case.

THE SURVEY

In summer 2016, a survey on the use of financial covenants was developed by the authors, and feedback was obtained from selected members of the leasing industry. To ensure a higher response rate, the survey was limited to 12 specific questions, plus one open-ended question at the end for respondents to add comments, if any.

With the assistance of the Equipment Leasing and Finance Association, approximately 350 survey links were sent to a cross section of ELFA members (bank lessors, independents, small ticket, and the like). A follow-up survey reminder was sent two weeks later. In addition, the authors sent the link to their leasing industry contacts. The result was a total of 87 responses. Table 1 shows the breakdown of respondents by type of organization.

Question 1 (as noted in Table 1) asked the respondent to check all boxes that apply. Thus, the numbers do not total 87 (the total number of responses), and the percentages do not total 100. For example, for bank lessors — 33 respondents in all — 4 also checked small ticket, 13 checked middle market, and 6 checked large ticket. The responses across all organization types are seen to be quite uneven.

Table 1. "Please check the boxes that best describe the majority of your business."

Organization	Number	Percent
Bank	33	38
Captive	10	11
Independent	32	37
Small ticket	18	21
Middle market	24	28
Large ticket	7	8
Law firm	5	6
Other service provider	2	2

Banks are heavily involved in loan products, and it would seem more logical for them to be comfortable with similar covenants in their leasing contracts.

We question the interpretative value of categories where respondents are few in number. It is doubtful, for example, that the opinions expressed by five law firms speak for law firms involved in equipment leasing in general. Our cutoff is admittedly arbitrary, but we decided to report on only the three largest groups: bank lessors (33), independents (32), and middle market (24). However, in the interest of completeness, we report an "all" respondents category, which includes everyone who responded.

Not all respondents answered every question. In the interest of full disclosure, the percentage of banks, independents, middle market, and "all" respondents is show in the appendix. When reading through this article, note that the questions that were answered by the majority of respondents are more credible than questions eliciting fewer responses.

The questions eliciting the fewest percentage of responses are questions 3, 4, 5, and 9. All other questions had response rates over 90%. Thus, the interpretation of answers for these four questions is less representative than for the other eight questions. For ease of navigation, we put the percentage responding in parentheses under the firm type in each table.

QUESTION 2: STATUS OF USING FINANCIAL COVENANTS

The difference in the use of financial covenants varies substantially among bank and independent lessors. Fully three-quarters of independents do not employ financial covenants, and only 16% have increased their use over the past few years. By contrast, only 38% of bank lessors do not use financial covenants, and 47% have increased their use. The results for middle market are about halfway between banks and independents. The reader is reminded that middle market is not a mutually exclusive category, as a number of banks and independents checked the middle-market category as well.

The heavier use of financial covenants by banks supports the anecdotal evidence the authors had observed six years ago. Banks are heavily involved in loan products, and it would seem more logical for them to be comfortable with similar covenants in their leasing contracts.

Almost 60% of all respondents indicated they do not use financial covenants. However, fully 30% indicate they have increased the use of financial covenants in recent years.

QUESTION 3: WHY FINANCIAL COVENANTS ARE NOT USED

The most important reason checked by bank lessors for *not* using financial covenants is "adverse effect on sales." The banks also indicated their second most important reason was their having other mechanisms for achieving the same goal. Adverse effect on sales represented approximately a quarter of the responses for all three groups. However, the most significant reason for

Table 2. "Describe the use of financial covenants in your contracts." (percentages reported)

Possible response	Bank (97)	Independent (100)	Middle Market (96)	All (93)
We do not have financial covenants in our contracts.	38	75	52	58
We have started using financial covenants recently.	6	3	4	5
We have increased the use of financial covenants over the past few years.	47	16	26	30
We are currently reviewing and considering adding financial covenants.	9	6	17	7

independents is "never gave it much thought." For middle-market players, almost half either indicated "never gave it much thought" or "adverse effect on sales."

Surprising (to the authors) was the token response to enforcement. Conversations with individual lessors suggested this could be an enforcement or monitoring nightmare, but the survey evidence indicates it is not seen as a significant reason for not incorporating financial covenants.

The "all" respondents category indicated the more important reason for not using financial covenants is an expected adverse effect on sales. This was followed closely by the belief that they would be too cumbersome to enforce.

The "other" response category drew 18 responses. The most frequent responses given in this open-ended narrative form were as follows. Eight said they rarely used financial covenants but will on a case-by-case basis and usually based on credit and size of transaction. Five respondents indicated they did not use financial covenants either because it would not work for their kind of business or because they dealt with high-quality credits. The other five responses were scattered over several reasons.

QUESTION 4: WHY FINANCIAL COVENANTS ARE USED

Why are financial covenants used? Question 4 asked, If you *do* employ financial covenants, what is the main reason? Here, wanting consistency between lease and loan contracts was either the most important reason for employing them or was tied for the most important reason. Tied for first among independents was the response that they are experimenting with them.

The authors had theorized that pressure from affiliates or concern over defaults would have been of paramount importance, but they were not. Between 11% (independents) and 27% (middle market) gave credit issues as a reason for including financial covenants. This is significant but not nearly as significant as many would have believed. The "other" category was checked by 18% (middle market) to 44% (independents).

The "all" respondents category indicated the two most important reasons for using financial covenants are consistency of requirements (between leases and loans) and concern over credit issues. These reasons appear mostly aligned with bank lessors.

The "other" category for this question generated 12 responses. Two-thirds of these respondents indicated the use of financial covenants was on a case-by-case basis and usually for high-risk or high-exposure deals. Three indicated the question was not applicable to their business.

Table 3. "If your company does *not* incorporate financial covenants into your contracts, which of the following best describes your position?"

Possible response	Bank (55)	Independent (84)	Middle Market (71)	All (66)
Never gave it much thought	11	30	24	18
Not a priority for us	11	22	12	19
Adverse effect on sales	22	22	24	26
We considered it, but decided it would be too cumbersome to enforce	6	15	18	24
We have other mechanisms for achieving the same goal	17	11	6	11
Other	39	26	41	32

Table 4. "If your company *does* employ financial covenants, which of the following best describes your position?"

Possible response	Bank (67)	Independent (28)	Middle Market (46)	All (47)
We want consistency of requirements between our loan and lease contracts.	27	22	45	24
Our parent or affiliate insisted.	18	11	18	12
We became concerned with credit issues or had a bad result in a default in recent years.	18	11	27	24
We felt our lease contracts were not strong enough without them to protect our interests.	9	11	0	10
We are experimenting with them to see if it makes a difference.	18	22	9	17
Other	23	44	18	29

Our survey results are consistent with Demerjian's findings, as cash flow and debt coverage ratios are generally more important than balance sheet ratios.

QUESTION 5: TYPES OF FINANCIAL COVENANTS USED

Debt coverage ratios are by far the most important financial covenant to both banks and middle market. (Remember, we may be double-counting due to some companies checking both bank and middle market as their type of company.) Independents marked cash flow ratios as most important, but also half of them checked debt coverage ratios as well. Minimum net worth and debt ratios were significant, but both are static, representing what a company has or owes. It is significant that cash flow and debt coverage ratios were given high marks, and they may both be described as "ability to pay" variables.

This is consistent with a study of loan covenants by Demerjian (Peter R.W. Demerjian, "Financial Ratios and Credit Risk: The Selection of Financial Ratio Covenants in Debt Contracts," working paper, University of Michigan, Ann Arbor, January 2007). In his analysis of thousands of loan contracts, Demerjian found "ability to pay" ratios to be used most often in loan contracts, followed by three static balance sheet line items or ratios. One ability to pay ratio was "debt to cash flow," which uses one line item from the balance sheet and one line item from the income statement or statement of cash flows. Our survey results are consistent with Demerjian's findings, as cash flow and debt coverage ratios are generally more important than balance sheet ratios.

Eight answered "other." Three indicated the answer was none, or the question was not applicable to their business. The other five indicated they used one or more of the following: liquidity, net worth, debt coverage, fixed-charge coverage, and loan-to-value ratios. (Most of these ratios or levels are included in the survey question, but five respondents chose to provide their own answer anyway.)

QUESTION 6: IMPRESSION OF THE USAGE OF FINANCIAL COVENANTS

This high-response-rate question indicated, overwhelmingly, that bank lessors, independents, and middle-market companies believe financial covenants are present in only a relatively small number of cases (50% to 70% of respondents). Only a relatively small number of respondents in each category felt these covenants are becoming more widespread (12% to 19%). This suggests that the respondents generally believe the level of use of financial covenants has plateaued and is relevant only in a "small number of cases."

The "all" respondents category chose, by far, the response that it is present in only a small number of cases. This is consistent with the other three groups presented in this study.

Table 5. "What type of financial covenants do you include in your contracts generally?" (Check all that apply.)

Possible response	Bank (73)	Independent (25)	Middle Market (50)	All (49)
Minimum net worth, total assets, or similar tests	21	38	50	30
Total debt, debt to equity, or similar tests	42	38	33	40
Cash flow ratios	33	88	50	42
Debt coverage ratios	79	50	92	70
Other	21	13	8	19

Table 6. "What is your impression of the leasing industry's use of financial covenants in leasing contracts?"

Possible response	Bank (100)	Independent (100)	Middle Market (100)	All (98)
No idea what the trend is	15	31	21	27
Believe it is becoming more widespread in leasing contracts	12	19	17	14
Believe it is present in only a relatively small number of cases	70	50	54	56
Believe it is a fad, and usage is declining as lessors remove financial covenants	3	0	8	2

QUESTION 7: TRAINING

The results of this high-response-rate question were quite interesting. Bank lessors indicate some training. Independents checked no training in 58% of responses. Similarly, middle-market companies indicated no training in 38% of responses. Some small amount of training was checked by 33% of middle-market companies. In no case is training widespread.

We must interpret these results with some caution. Arguably, training is not essential if personnel are already knowledgeable. And would be more important if it were a skill set most personnel lacked. Bank lessors indicated significant training or widespread training in 36% of respondents, while independents and middle-market companies checked those boxes in only 12% and 30% of all cases, respectively. To summarize, independents indicated no training 58% of the time. No training fell to only 38% and 24% of respondents in the case of middle-market and bank lessors, respectively. Training to a small degree was 39% for banks, and 29% to 33% for independents and middle market companies, respectively.

The "all" respondents category responses align most closely with middle-market responses. "No training" and "yes, but to a small degree" were the most common responses.

QUESTION 8: SHOULD FINANCIAL COVENANTS BE REQUIRED?

The "no" response was virtually the same for all three categories at 12% to 13%. Independents marked "no, we should distinguish ourselves from lenders" in 17% of responses, while bank and middle-market companies thought this was essentially a nonissue. By far the prevalent response for all three categories was "sometimes, for weak credits or weak collateral only." This was the response in 43% to 67% of all respondents. The bottom line is that financial covenants should be required when credits or collateral are weak.

The "all" category most closely aligns with independents and middle-market companies. As with those two groups, the one major response was to use financial covenants sometimes, for weak credit or weak collateral deals.

Question 8 drew 11 "other" responses. The one response gathering the most comments was that it would be all right for larger exposure transactions but not for smaller ticket. Two-thirds responded along these lines. The other four responses were scattered.

QUESTION 9: WHAT DRIVES USE OF FINANCIAL COVENANTS?

The response to "what is the driving force" behind the use of financial covenants is overwhelmingly attributable to mitigating risk. Other responses pale in comparison. Lawyers received a pass entirely for being the force behind the use of financial covenants. Pressure

The response to "what is the driving force" behind the use of financial covenants is overwhelmingly attributable to mitigating risk. Other responses pale in comparison.

Table 7. "Do you train credit, operations, legal and/or others in your firm in the meaning and significance of financial covenants?"

Possible response	Bank (100)	Independent (97)	Middle Market (100)	All (95)
No, no training	24	58	38	40
Yes, to a small degree	39	29	33	37
Yes, to a significant degree	27	6	17	17
Yes, training is widespread	9	6	13	6

Table 8. "Should equipment lease contracts include financial covenants?"

Possible response	Bank (100)	Independent (94)	Middle Market (100)	All (94)
No, it is not part of our industry.	12	13	13	16
No, we should distinguish ourselves from traditional lenders.	3	17	8	7
Sometimes, for weak credits or weak collateral only.	67	43	67	54
Yes, it provides a significant benefit.	18	10	17	15
Yes, we are no different from other lenders.	3	3	0	2
Other	3	23	4	15

if covenants are not monitored for compliance on a regular basis, the lessor may have that right waived if litigation ensues.

from regulators was given as the driving force in only about 20% of responses from each category.

It is also logical that independents would select "pressure from funding sources" significantly more than banks or middle-market firms, since they are much more dependent upon outside financing. However, we must also note this is a relatively low response rate question, eliciting responses from 82% of the bank respondents, 67% from middle market, and a very low 31% of independents.

The "all" category appears most closely related to middle-market companies. By far the most important use of financial covenants for the "all" group is management's attempt to mitigate risk. This is very close to the middle-market group: middle-market companies gave this reason 81% compared to a close 76% for "all."

QUESTION 10: SPRINGING COVENANTS

This question was answered by virtually all bank, independent, and middle-market respondents. For each of our questions that would not apply if the respondent does not use financial covenants, the respondent can select "we do not use financial covenants." Springing covenants are covenants that would be activated only if a base covenant is violated. A very small proportion of lessors in any of the three categories reported having springing covenants. Such "second-level" covenants are used by only 7% of responding independents and 16% to 17% of bank and middle-market lessors.

The "all" group gave responses similar to the other three groups. Only 14% have additional covenants that come into play if a base covenant is violated, which is virtually the same as bank and middle-market companies. We conclude that springing covenants are not an issue to most lessors.

QUESTION 11: MONITORING

How are covenants monitored? That is the focus of question 11, summarized in responses in Table 11. A large percentage of lessors once again indicated they do not employ financial covenants. The second and third choices we offered lessors were (1) we monitor riskier credits and (2) we monitor all lessees.

Logically, one might think covenant monitoring would be more prevalent with riskier credits, but to an overwhelming extent the responses for bank and middle-market lessors rated all contract monitoring as the case. That independents did not rate "all contracts" monitoring as more prevalent may be simply due to not employing financial covenants much to begin with. However, if covenants are not monitored for compliance on a regular basis, the lessor may have that right waived if litigation ensues.

All respondents marked periodic monitoring for riskier lessees with the same frequency as virtually all three other categories. It is interesting to note that "all" was much less inclined to monitor financial covenants for all contracts — with only half the frequency of bank and middle-market lessors.

Table 9. "What is the driving force behind using financial covenants in your organization?" (Select all that apply.)

Possible response	Bank (82)	Independent (31)	Middle Market (67)	All (53)
Pressure or requirements of regulators	19	20	19	17
Management being pressured by their lawyers	0	0	0	2
Management in an attempt to mitigate risk	89	60	81	76
Pressure from funding sources	4	20	13	13

Table 10. "Do your contracts contain 'springing' covenants? (that is, covenants that are triggered only if a base contract covenant is tripped)"

Possible response	Bank (97)	Independent (91)	Middle Market (96)	All (90)
No, we do not use financial covenants.	34	79	52	55
No, we use financial covenants but do not have a second layer that comes into play if a base covenant is violated.	50	14	30	31
Yes, we have additional covenants that come into play if a base covenant is violated.	16	7	17	14

QUESTION 12: COVENANT BREACHES

Banks have a case-by-case basis policy of curing breaches, more so than their other responses and much more so than independents and middle-market organizations. Independents are less likely to "work with their customer" (3%) than they are to inform the customer of a breach and indicate the time to cure. Banks and middle-market firms are more likely to work with a customer, and more likely to inform a customer of a breach than independents.

Handling breaches of financial covenants on a case-by-case basis was the most important to the "all" category, which mirrored the middle-market category most closely. The other two explanations were checked by "all," banks, and independents with similar frequency.

QUESTION 13: SOLICITED OPEN-ENDED RESPONSES

"Please tell us, in your own words, anything additional you would like to add to this conversation on financial covenants."

This was the only completely open-ended question asked in this survey. Twenty-four responded, but two had nothing to add. The following commentary attempts to develop a composite of the 22 usable comments. Those that use covenants (10) do so for large-ticket and significant credit-risk customers. Covenants were not deemed useful or too burdensome for small to middle-market deals. The six that do not use financial covenants said they have other tools such as scorecards or risk predictive tools.

A general belief is that financial covenants are for banks or larger ticket deals, or to use when credit risk is a concern.

Table 11. "How do you monitor financial covenants?"

Possible response	Bank (97)	Independent (97)	Middle Market (96)	All (92)
We do not use financial covenants.	28	81	43	55
We periodically monitor financial covenant compliance for our riskier lessees.	16	13	13	18
We periodically monitor financial covenant compliance for all our contracts.	56	6	44	28

Table 12. "How do you handle the breach of a financial covenant?"

Possible response	Bank (97)	Independent (94)	Middle Market (96)	All (92)
We do not use financial covenants.	25	80	43	50
We bring a breach to the attention of our customer and try to work them back into compliance.	16	3	17	10
We inform a client they have breached a financial covenant and indicate they have a specified period to cure the breach.	19	10	21	14
We handle breaches on a case-by-case basis — no set procedure.	41	7	17	26

SUMMARY AND CONCLUSIONS

Based on the survey, a few general observations appear justified:

1. Independents, by far, use financial covenants the least. (75% do not.)
2. There is no single, commonly cited reason for not using financial covenants in lease contracts. The most common reasons given by bank lessors were adverse effect on sales and having other mechanisms for achieving the same goal. Independents and middle-market companies indicated adverse effect on sales and "never gave it much thought."
3. When financial covenants are employed, banks, independents, and middle-market companies all indicated consistency between lease and loan products as the main reason for employing them.
4. Specific financial covenants used most often are debt coverage, cash flow, and debt ratios. While cash flow ratios are much more important to independents, debt coverage is more important to banks and middle-market companies.
5. The overwhelming response by all three company types is that financial covenants are not frequently utilized and included in lease contracts.
6. Training in the use of financial covenants is not widespread, but it is higher for banks than independents.
7. As to whether leasing contracts should include financial covenants, the largest response was that they should be used sometimes, and for weak credits or deals with weak collateral.
8. Most frequently, financial covenants are used "in an attempt to mitigate risk."

9. Very few respondents used "springing covenants," which are covenants activated by breaching a base level covenant.
10. Banks and middle-market leasing companies are much more likely to monitor covenant compliance than independents. Covenant breaches are handled on a case-by-case basis in the case of banks, and informing the customer they have breached in the case of independents and middle-market companies.

Where does this leave us? The consensus is that — contrary to the anecdotal evidence shortly after the 2008–2009 market turmoil — lessors have not embraced the use of financial covenants. As may be expected, these loan-type provisions are more likely to be used by banks than independents, in larger transactions and for weaker credits and weak collateral deals.

It appears that, after a brief flurry of activity, equipment finance has returned to the old rubric that equipment finance focuses on the equipment collateral, rather than on the credit criteria employed by traditional lenders.

APPENDIX. Percentage of Respondents Answering Each Question

Question	Bank	Independent	Middle Market	All
1	100%	100%	100%	100%
2	97	100	96	93
3	55	84	71	66
4	67	28	46	47
5	73	25	50	49
6	100	100	100	98
7	100	97	100	95
8	100	94	100	94
9	82	31	67	53
10	97	91	96	90
11	97	97	96	92
12	97	94	96	92

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A Cape Town Protocol for Marine Assets: What Can We Agree on Right Now?

By Michael Kim

The Cape Town Convention on International Interests in Mobile Equipment has served financiers of aircraft and their counsels very well. Such is not the case, however, with the ship finance industry. This article examines past attempts to develop a marine protocol, addresses whether cross border maritime issues are too difficult to fix, and proposes steps and guidelines for tailoring a workable protocol. Momentum may build once an initial set of principles is agreed upon.

To financiers of aircraft and their counsels, the Cape Town Convention on International Interests in Mobile Equipment (CTC)[1] has been a trusty friend in cross border transactions for many years, providing assurance as to the priority of competing liens, foreclosure, and enforcement rights and remedies in and out of bankruptcy with respect to airframes and engines.

The rationale behind the CTC is that, by harmonizing such security rights and providing legal certainty across many jurisdictions, the transaction costs of financing are lowered, and there is greater access to capital markets, especially in those jurisdictions which otherwise have less developed property law regimes.

In the ship finance industry, however, there has not been a similar reception and harmonization. There is a natural analogy from aircraft to vessels. Although vessels do not move with the rapidity and frequency of aircraft, both types are high-value goods that cross jurisdictions and are subject to different legal regimes, depending on where the movable assets are at any given time.

Moreover, a protocol for ships would appear to be a logical extension of the existent national registration systems for ships already common worldwide and the ostensible need for harmonization, given the cross border mobility. If done properly, there could be a great deal of value in a protocol for ships and, by extension, other marine assets.

The question of whether now is the right time for a marine protocol is partly answered by looking at why it has not already happened.

PAST ATTEMPTS TO DEVELOP A PROTOCOL

As early as 1996, UNIDROIT[2] considered the question of applying the CTC in some form to ships. On the heels of the 1993 adoption by the United Nations of the International Convention on Maritime Liens and Mortgages (International Convention), UNIDROIT was in wait-and-see mode to see how the rules under the International Convention would be finalized before embarking on a project to develop a protocol.

UNIDROIT has since realized that the International Convention has not attracted widespread participation from countries. Interestingly, in 1991, the European Commission explored the idea of a European Union ship registry but abandoned it, citing the lack of harmonization among the economic, tax, and social policies of its member states. It was a chastening lesson that the underlying laws of the states were driving what the international law should be, rather than vice versa.

In 2013, UNIDROIT released an optimistic preliminary study (the 2013 study) regarding the CTC's application to ships and maritime transport equipment (the Marine Protocol), and noted that it would continue to monitor developments in the field by conducting feasibility studies.

Since then, however, nothing definitive has happened, probably because of the lack of interest shown by maritime industry groups. One reason is that traditionally, in the vessel space, there are international organizations that have the full participation of shipping circles, and they may view

any uniform international law as unnecessary. Without their support or momentum, it would be difficult to develop such a protocol.

The list of nonconsensual maritime liens can vary widely from one legal system to the next. It is a highly disputed area where no broad international consensus has been reached.

Given the resistance within the industry, in its May 2014 session and again in its May 2016 session (the 2016 study), UNIDROIT assigned low priority to a proposed marine protocol.

TOO COMPLEX TO FIX?

But cross border maritime issues will not go away. A Brazilian case in February 2016 brought to the industry's attention once again that a handful of jurisdictions do not acknowledge ship mortgages under a foreign law of the flag. Such jurisdictions do not recognize, as readily enforceable, ship mortgages recorded with an open registry such as Panama, Liberia, or the Marshall Islands.

In this case, a Sao Paulo court held that a Liberian ship mortgage, granted in favor of a Nordic trustee, would not be recognized under Brazilian law because Liberia had not ratified the Brussels Convention on Maritime Liens and Mortgages of 1926 or the Bustamante Code of Private International Law of 1928.

Another example: when deciding priority as to security rights, most jurisdictions will apply the law of the flag. However, in some jurisdictions, such as Canada or New Zealand, the law of the forum will be applied, and there is no submission to the application of any foreign law of the flag.

What UNIDROIT and traditional maritime industry groups face is the sheer complexity of any harmonization of the existing maritime international regimes. Consider the interface between the shipowner's national laws and the laws of the registry's jurisdiction, and how the choice of registry for a ship subjects it to that nation's safety regulations, labor laws, and operational rules for a ship.

As maritime finance lawyers know too well, there can be different specific requirements to registration depending on the jurisdiction, such as the notarization of the mortgage deed or security agreement, use of specific forms, and attestation of shipowner's signature. Some jurisdictions also allow for registration in different places, in a foreign consulate of the flag state or consulates in the most important port cities.

Consider, too, the reality of forum shopping practices, whereby a ship mortgagee may orchestrate a ship to travel to a port in a favorable jurisdiction — meanwhile, the ship's nonconsensual maritime lien creditors would seek to exercise their possessory lien before the ship leaves port in order to prevent it from traveling to a jurisdiction that grants less preferential priority status to such liens.

Nonconsensual liens present a particular headache in any harmonization effort. Nonconsensual liens, which, in many jurisdictions often take priority over registered liens, can be contractual (such as for seamen's and master's wages or contracts for repair of the ship) or arise by operation of law (such as claims for liability in tort) and in some jurisdictions entail statutory rights of retention, whereby the creditor would retain possession of the ship until its claims are paid and satisfied.

The list of nonconsensual maritime liens can vary widely from one legal system to the next. It is a highly disputed area where no broad international consensus has been reached. National regimes understandably would want to ensure that maritime liens, which often arise in favor of local creditors, are not diminished by the recognition of foreign security rights.

In some jurisdictions, issues of priority, in particular with respect to nonconsensual liens, are viewed as procedural in nature and thus subject to the application of the law of the forum. In others, it is an issue of substantive law and governed by the *lex causae* of the underlying claim — that is, the law that is applicable for the claim secured by the nonconsensual liens — and under that approach, neither the location of the ship's registry nor the choice of forum affects what law is applied.

A third approach is the application of the law of flag rather than law of the forum or law governing the maritime claim. This could present a problem, however, given the widespread use of flags of convenience where shipowners have registered a vessel under the laws of a state without any meaningful connection to the ship. This then may result in there being an absence between the circumstances that give rise to a maritime lien claim and the law of the flag. There would be strong competing arguments as to which jurisdiction should apply.

Moreover, a marine protocol would need to address the possible conflict-of-laws situation if, in a particular jurisdiction, the law of the location of the ship *(lex rei sitae)* governs nonconsensual security rights, while, with respect to the priority status of consensual security rights, the law of the flag is applied.

A marine protocol may also face obstacles in dealing with

civil law jurisdictions, where typically the principle of possession is central to a pledge over movables, and such jurisdictions have been resistant to a flexible security rights system such as Article 9 of the Uniform Commercial Code in the United States. Hypothecation in a civil law system was historically restricted to immovables.

Should a marine protocol attempt to broaden what is covered by existing registry regimes? The 2013 study's proposed international vessel registry covering ships and marine equipment suggested that "ship" be defined as "any self-propelled sea-going vessel used in international seaborne trade for the transport of goods, passengers, or both with the exception of vessels of less than 500 gross registered tons."[3]

Rather than such limitation, should a marine protocol apply to all marine assets, such as barges, containers, floating dry docks — in sum, anything capable of movement over water, whether or not self-propelled? The broadening of the scope of covered assets would allow jurisdictions that (despite having an established open registry) permit mortgages to be registered over only vessels, to provide the same commercial assurances over a wider swath of marine assets.

Such an increase in scope would enable lessors and secured lenders for, as an example, containers, to enjoy the same degree of legal protection that they currently possess for the vessels on which the containers are shipped.

WHAT CAN WE AGREE ON NOW?

Given the past history and the current complexities in maritime law, a marine protocol should be highly tailored and offer specific practical guidelines. This was the spirit of the 2013 study, which spoke of a "harmonization project … limited in scope stand[ing] a greater chance of success than previous attempts at achieving comprehensive international regulation of proprietary security interests over ships."

The first step could be to establish an international registry with uniform rules on (1) creation of consensual liens, (2) third-party notice, and (3) priority and remedies. Depending on what is accepted by the industry as most efficient, the protocol could either dispense with the need to fulfill different formal registration requirements under various national laws or require filings in both systems (as in the case of the Cape Town aircraft protocol, where a FAA filing must be made prior to recording in the international registry for aircraft).

Such a registry should permit for now only consensual liens over ships — rather than a broader class of any marine assets, with the caveat that if sufficient industry support exists, the registry could also cover barges and containers. A marine protocol extending to such class of assets could prove hugely beneficial to creditors and shipping companies.

Take the example of the recent bankruptcy filing of Hanjin Shipping Co., the largest shipping company in South Korea, the timing of which has resulted in the refusal of ports to receive Hanjin's cargo. This action has stranded, according to *The Wall Street Journal*, not only 45 ships at sea but also more than a half million containers.

In addition, historically, national registries have had exemptions for smaller ships, so a minimum tonnage requirement or the vessel size requirement may be useful and necessary.

Even if nonconsensual maritime liens are not to be covered by a protocol (because of local political and commercial reasons cited above), there would be a benefit to debt and equity investors from having a unified, global registry for consensual liens.

The international registry should be an electronic registry, searchable by both asset-specific description and general debtor-indexed names, as in the case of most national registries. It would be easily accessible to creditors and vessel owners desiring to check on the priority of consensual security rights. Moreover, an electronic registry would avoid the cost, expense, and delay associated with shipping registers operated on a paper basis.

The first to file an international interest (after filing in their national registry, as in the case with the FAA for U.S. aircraft under the Cape Town aircraft protocol) would have priority. Exceptions could be considered, such as in a few jurisdictions that override order of registration in the case of a secured creditor that knew or should have known of the existence of an earlier security interest.

> There is widespread acceptance by most legal systems of the principle that the creation and third-party effectiveness of consensual security over ships is governed by the law of the flag.

There is widespread acceptance by most legal systems of the principle that the creation and third-party effectiveness of consensual security over ships is governed by the law of the flag — that is, the law of the state where ownership of the vessel is registered, regardless of the forum or the law of the place where the ship is located at any given moment. The Marine Protocol should adopt such approach, as well as look for other aspects where there already is established unanimity.

A marine protocol could achieve a major breakthrough by establishing a searchable, electronic registry for both recorded consensual security interests and permissive notice filing of nonconsensual liens under local law.

A narrow approach could have a corollary component of look ing to the national requirements according to the applicable law of the flag of the vessel, obviating the need for certain definitions within the Marine Protocol itself (such as "ship" or "container" as defined by the U.S. Department of Transportation).

Perhaps agreement could be reached over "core" categories of nonconsensual liens that would have priority over a registered international interest, by recognizing liens arising under the law where the ship repair or seaman's injury occurred. Again, if there is support in the industry, the protocol could allow for permissive notice filing of nonconsensual liens, for example a shipyard's or stevedore's liens.

In sum, the Marine Protocol should do what can be done for now. It would leave well alone the arrest of ships, which has been addressed by the Geneva Convention on the Arrest of Ships of 1999, adopted by a substantial number of countries. UNIDROIT should continue its feasibility studies and solicit input from the industry circles in the nations mostly likely to adopt and benefit from having a marine protocol.

Momentum may build once an initial set of principles are agreed upon. The Comité Maritime International is currently working on a projected International Instrument for the Recognition of Judicial Sales of Ships. The Marine Protocol could address the sale of assets during the enforcement phase, rather than all rights and remedies. Specifically, the protocol could provide that, upon default, the mortgagee can exercise a right to repossess, exercise control over the ship and enjoy its earnings, and satisfy the secured claim out of the proceeds of either a judicial or an out-of-court sale of the ship.

In the latter sale, the ship would be sold free of maritime liens and other encumbrances, no warranties would be given by the mortgagee, and the mortgagee would not face any potential liability to the original vessel owner in the event of a failure to achieve the maximum possible sales price.

Lastly, the Marine Protocol could be an impetus for national laws in jurisdictions that are either lagging behind or in need of an overhaul of their respective property law regimes. At the African Maritime Conference in Lagos, Nigeria, in September 2015, the UNIDROIT Secretariat, who attended at the invitation of the African Shipowners Association, expressed the idea that a marine protocol could enhance African shipowners' access to foreign capital and reduce transaction costs.

The strongest interest, in fact, may come from such jurisdictions with less developed property regimes, which may be eager to sign on. The Marine Protocol could have a profound benefit to emerging markets where credit may be limited and shipowners may lack access to funding.

CONCLUSION

Opponents of a marine protocol should not dismiss it out of hand. A marine protocol could achieve a major breakthrough by establishing a searchable, electronic registry for both recorded consensual security interests and permissive notice filing of nonconsensual liens under local law. By targeting the particular areas where there is consensus within the maritime community, proponents of a marine protocol could achieve success before the end of this decade.

Endnotes

1. The implementation of CTC to aircraft equipment is through the Protocol to the Convention on Matters Specific to Aircraft Equipment, which took effect March 1, 2006, and as of the date hereof has been ratified by 64 countries.

2. International Institute for the Unification of Private Law *(Institut International Pour L'Unification du Droit Prive)*.

3. That definition comes from Article 2, Geneva Convention on the Conditions for the Registration of Ships of 1986.

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M&A Has Rapidly Changed the Canadian Commercial Equipment Finance Marketplace

By Hugh Swandel

Since the global crisis of 2008, consolidation and change have redefined the major players in the Canadian leasing industry. As with other types of financial services, the leasing industry was trying to understand a situation few had predicted and none could navigate with certainty. Banks and credit unions have gained market share at the expense of independent and foreign lessors. This article explains how those changes occurred and what they may portend.

In recent years, the Canadian commercial equipment finance marketplace has undergone consolidation and changes that have redefined the major players in the industry (Figure 1). The drivers that created all this change include the credit crisis, the aging of independent owners and operators, and the consequences of designating General Electric Capital Corp. Inc. (GE) as too big to fail.

The credit crisis of 2007–2008 appears to have been the catalyst for a constant stream of more than 35 M&A transactions that have realigned market shares held by the various constituents in the industry. As Table 1 indicates, banks and credit unions have gained considerable market share at the expense of independent and foreign lessors in Canada.

AGENTS OF CHANGE

How did these changes happen, and what are the consequences for the future of the Canadian commercial equipment finance industry? Most industry executives would agree that the global collapse of credit markets was an event that few predicted. Fewer still could have understood the consequences of the rapid deterioration of the operating environment for commercial equipment finance companies. Many commercial equipment finance firms had to reevaluate their future in the industry, while others would see the changing environment as an opportunity to gain valuable market share and new product lines.

These were challenging times for finance companies in Canada. Large numbers of lessors relied heavily on the insurance industry, public market securitization, and bank syndicates as sources of funding. Virtually overnight, public market securitization for commercial equipment finance in Canada halted and did not recover for years. Some insurance industry sources, concerned with their own liquidity and sources, increased the cost of capital significantly and with little notice.

Banking community uncertainties about their own liquidity meant that nonbank finance companies found their existing facility sizes reduced and deal terms altered. During this period, shareholders and executives were scrambling for options that would help them survive.

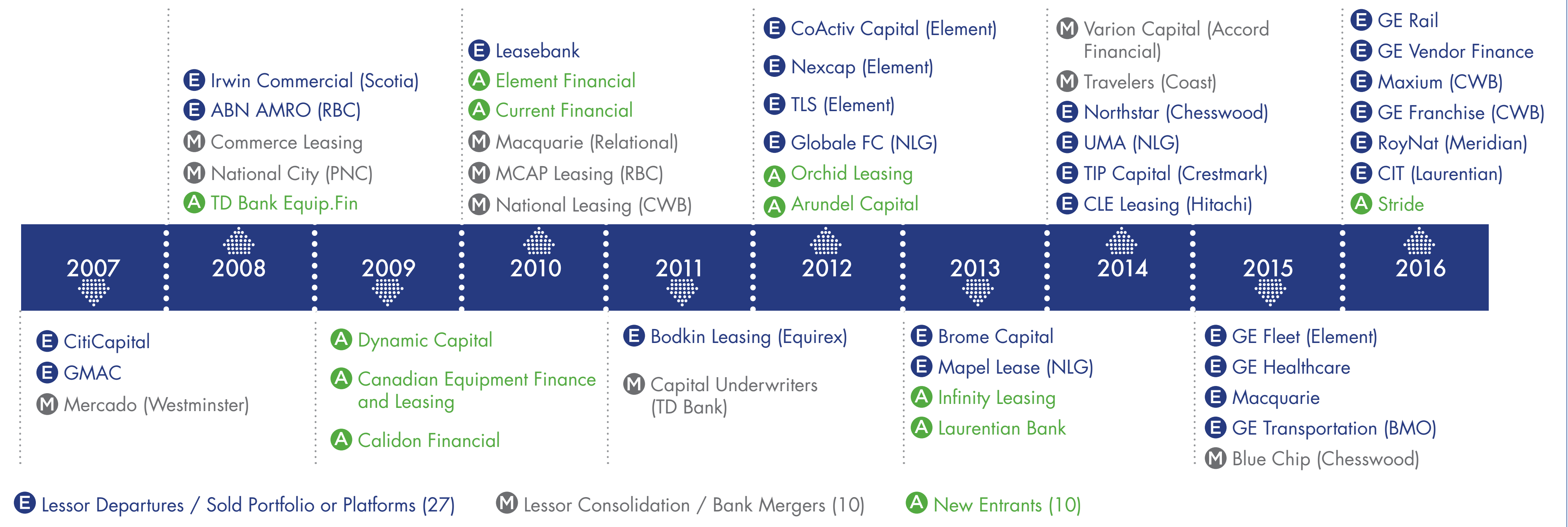
The Canadian Finance & Leasing Association (CFLA), like other financial services associations around the globe, was trying to understand a situation few had predicted and none could navigate with certainty. The CFLA focused on lobbying the federal government to provide solutions to the lack of available capital for nonbank finance companies, includ-

Table 1. Change in Canadian Market Share, 2013–2016

	2016	2013	Change
Captive finance companies	11.7%	12.0%	-2.9%
Banks and credit unions	70.5%	62.0%	13.6%
Government agencies	8.8%	10.0%	-11.6%
Independent and foreign	7.0%	14.0%	-50.3%
Insurance	2.1%	2.1%	0.0%

Sources: Alta Canada proprietary database, CFLA.

Figure 1. Noteworthy Exits, Mergers, and Arrivals



Source: The Alta Group.

Table 2. Some Facts About the Canadian Market

Equipment Finance Market Size Estimates

CDN $ millions	2015	2013	% change
Private sector spending			
New financing	$29,039	$28,498	2%
Spending on M&E	$72,824	$64,845	12%
Finance share	40%	44%	
Public sector spending			
New financing	$5,707	$5,767	-1%
Spending on M&E	$14,313	$13,123	9%
Finance share	40%	44%	
Equipment finance market size			
New financing	$34,747	$34,265	1%
Spending on M&E	$87,137	$77,967	12%
Finance share	40%	44%	

Sources: Statistics Canada, CLFA.

ing captive finance arms of manufacturers and independent finance companies.

Experiencing periods of low liquidity is nothing new for finance companies, but the severity of the events of these years was unprecedented and unanticipated. Although some firms acknowledge that the liquidity crisis directly caused the sale of their companies, other factors were also at work over a number of years.

EMERGENCE OF ELEMENT CAPITAL

Perhaps the best example of change caused by the 2008 financial turmoil and resulting frozen credit markets was the founding of Element Financial by Steve Hudson. While the financial community was struggling with a lack of liquidity and an unclear lending climate, a prescient Hudson saw an opportunity to pursue the acquisition of companies, assets, and talented executives made available by a nervous industry. In a relatively short span of time, Element Financial has created two of the largest finance firms in North America.

The original intent was for Element to be a Canadian equipment finance firm, so the first acquisitions were Canadian independent equipment lessors. It could be said that the efforts of Element to find acquisition targets planted seeds with a number of owners who later did sell, but not to Element.

The company that grew into the Element we know today began in 2010 when a private investor group led by Hudson acquired what was then a very small independent commercial equipment finance company, Element Financial. Element came to the acquisition market when some of the best Canadian companies had already been sold or were in the process of selling. Scotiabank acquired Irwin Financial in 2008, Canadian Western Bank (CWB) acquired National Leasing in 2010, and Royal Bank of Canada (RBC) acquired MCAP Leasing later the same year.

These three companies all had a strong track record and were among the largest independent finance companies in Canada at the time. The banks acquiring these companies offered a viable long-term solution to the sellers' treasury issues, and the deal terms were strong enough to adequately reward selling shareholders.

In the case of Scotiabank, the acquisition of Irwin Canada gave it a vendor-focused sales force with a strong reputation and a management team with a long history of providing results for a variety of shareholders.

After the acquisition in 2008, the Irwin team was rebranded under Scotiabank's subsidiary RoyNat Lease Finance. Over the span of eight years, the portfolio grew from $400 million to $1 billion in assets under management. In 2016, Scotiabank sold RoyNat Lease Finance to Ontario-based Meridian Credit Union, citing a desire to pursue larger ticket transactions.

CWB acquired National Leasing in 2010 at a time when the company had long been the target of acquisition suitors desiring the strength of National's award-winning management team, strong corporate culture, and years of profitable origination growth. When the sale was made public, National stated that it had difficulty managing a complex treasury with a large number of funding partners and this was a contributing reason for selling.

CWB was a strong bank with a good balance sheet but had been criticized by investors and regulators for having high exposure geographically and to certain industries. National Leasing was a perfect solution for these issues as it provided assets across the country along with a sales force that delivered considerable diversity of credit, equipment, and geography.

National was allowed to operate as a subsidiary of the bank with only nominal changes in direction and influence from the new owners. The bank's treasury and balance sheet strength enabled National to consistently hit growth and profit targets.

At the time of the sale of National Leasing Group, there were a number of bidders for National including Royal Bank of Canada. RBC, which had been contracting with National Leasing to service its commercial equipment finance portfolio for a number of years, pursued other acquisitions after losing National to CWB. RBC subsequently acquired MCAP Leasing, and the servicing relationship with National was ended.

ACQUIRED FIRMS GAIN FROM BANK OWNERSHIP

Irwin, National, and MCAP had all competed with each other for years, and as each one sold to a bank with a very low cost of funds, the others had to compete with lower pricing against the strong balance sheets of the banks. The banks making these acquisitions were all subsequently rewarded with strong growth in originations and profits.

Element was seeking acquisitions at the time of the sale of National Leasing and MCAP but either arrived on the scene too late to entice these sellers or was passed over because the multiples paid on these transactions were beyond the scope of a publicly traded company.

Element subsequently began scouring the Canadian market for acquisition targets; when it saw only limited Canadian opportunities the company began to expand its appetite to include U.S. firms and firms engaged in fleet financing. The initial acquisitions by Element included the remaining portfolio of Alter Moneta, which was winding down at the time; NexCap Financial, a niche market equipment lessor; and TLS Financial, a Canadian fleet lessor.

In addition to these completed transactions, Element targeted most of the significant players in Canada and aggressively solicited acquisitions. By now, the Canadian market had witnessed a series of acquisitions by deposit-takers, along with the aggressive acquisitions of Element Financial, and this sparked several of the remaining players to begin considering how and when they would sell their businesses.

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The changes that started with a flurry of acquisitions continued as uncertainty and the altered competitive landscape caused more companies and executives to reconsider their options. Element continued to acquire in Canada but shifted focus to

larger acquisitions in Canada and beyond. Independent Canadian firms that had been pursued unsuccessfully by multiple buyers became intrigued after seeing deal terms that would make sense to their shareholders.

> The sheer size of GE Capital cannot be overstated. In 2013, the Monitor list of the top 100 commercial equipment financing companies had GE in the number one position and showed the total assets being managed as more than twice the size of the second largest firm.

Subsequently, Hitachi Capital entered the Canadian market by acquiring Canadian Leasing Enterprises. Chesswood Group acquired Northstar Leasing, Blue Chip Leasing, and Ecohome Financial. Other acquisitions continued with deposit-takers and foreign lessors adding strategic assets.

GE CAPITAL SOLD

As time passed, regulators began to propose new laws and requirements that in theory would prevent a future liquidity crisis. It is debatable whether these measures will truly prevent future market disruptions, but there were clear consequences due to the subsequent regulatory changes. The most significant consequence was the decision by GE to sell all its finance companies.

In July 2013, the U.S.-based Financial Stability and Oversight Council designated four nonbank financial companies as too big to fail, and this list included GE. The impact of this decision on GE was significant and was part of the reason that the company decided to return to its roots via restructuring the company. This decision of GE to sell the largest commercial finance company in the world has resulted in a number of transactions that are reshaping the industry in Canada and around the world.

The sheer size of GE Capital cannot be overstated. In 2013, the Monitor list of the top 100 commercial equipment financing companies had GE in the number one position and showed the total assets being managed as more than twice the size of the second largest firm, Banc of America Leasing. Since making the announcement to sell these businesses, GE has transacted multiple divestitures in Canada including sales to Wells Fargo Canada, Canadian Western Bank, Bank of Montreal, Element Financial, and other Canadian entities.

An additional consequence of the changes at GE Capital was the constant exodus of talented GE executives looking to leverage their years of experience into new opportunities. New firms were started and existing firms were expanded as a result of the GE changes. Laurentian Bank of Canada added a group of former GE executives who made a strong impact on the market. There are numerous other firms that have added GE people in senior management and leadership positions.

The dispersal of GE executives through the sale of business units and departures to new and existing firms will have a lasting and significant change on the industry in Canada and around the world.

As the GE transactions were completed, some additional M&A activity was also occurring with more deals recorded by Canadian deposit-taking institutions. In 2016, CWB announced the acquisition of Maxium Financial, an Ontario-based lessor that pursued larger ticket transactions than National Leasing Group and provided further geographic, industry, and equipment diversity.

Recently, CWB was the winning bidder for the GE Franchise finance assets and team in Canada. The needs of CWB exemplify what has driven many of the acquisitions by deposit-taking institutions in Canada. Deposit-takers buying equipment finance companies generally need to deploy capital rapidly, reduce their dependence on real estate based lending transactions, and generate strong margins.

Additional examples of institutions acquiring commercial finance companies include the Bank of Montreal acquisition of GE Transportation, the sale of RoyNat Leasing to Meridian Credit Union, and the acquisition of CIT Canada by Laurentian Bank of Canada.

WHAT HAPPENS NEXT?

The pace of change in the Canadian commercial equipment finance industry is unprecedented, and the full consequences of the change are yet to be determined. The shift in market share to financial institutions is similar to past trends in the United States. When larger banks had a high level of funds on deposit, they competed to acquire independent commercial equipment finance companies as a way to deploy capital and quickly improve results.

The companies making the acquisitions in Canada are in most cases large with competing institutional agendas. Over time, institutions often narrow their credit and product appetite, and this will be a sign to entrepreneurs to expand or start independent finance firms.

Some of the financial institutions that have made acquisitions appear to be integrating their acquisitions wisely, and these companies should continue to grow. Canadian Western Bank and Laurentian Bank seem well positioned for growth. The recent decision of Scotiabank to

sell RoyNat (formerly Irwin) after eight years of ownership is an example of an institution headed in the opposite direction from the time it made the acquisition.

Scotiabank cited a lack of interest in relatively smaller transactions as a key driver for selling the business. The buyer, Meridian Credit Union, has many small business customers, and the acquisition would appear to be a better strategic fit. Time will tell where recent acquisitions fit with bank acquirers' future plans.

The recent decline in oil, gas, and other commodity prices has put considerable regional strain on bank and credit union portfolios, resulting in amended credit policies. Some see these credit appetite adjustments as an overcorrection. Independent finance firms have succeeded by filling gaps in the lending markets that have been created by changes in traditional lender credit appetites. This could be the opportunity for existing and new independent lessors to gain market share.

The current community of independent companies may be small, but the leadership and talent in these companies are well positioned for expansion. Capital for independent firms is again abundant, and investors recognize there is opportunity in the market and strong management teams worth backing. It is expected that independents will experience strong growth and that the number of firms will increase.

One of the consequences of CFLA lobbying was the creation of a new source of funding for independent firms, which should ensure that a repeat of liquidity problems does not have the same impact on the independent community. The Business Development Bank of Canada (BDC), a bank owned by the federal government, is the provider through an intermediary, TAO Asset Management (TAO). The BDC and TAO are helping incubate new and smaller leasing companies, and as these firms increase in size, market share will once again change. The BDC and TAO are now playing a critical role in the rejuvenation of the independent finance community in Canada.

The most recent indications from Element Financial are that it continues to seek additional acquisitions that may include further activity in Canada. Element has approved the split of the company into a fleet company and a commercial equipment finance entity. Time will also tell how well Element can perform as it digests the numerous acquisitions since 2010.

CONCLUSION

The Canadian leasing industry is considerably different in 2016 from eight years ago, and much of that change was initiated by the unprecedented events starting with the collapse of credit markets in 2007–2008. The resulting climate of uncertainty led to numerous acquisitions by Element Financial, banks, credit unions, and other industry players.

Even without the sale of GE companies, the Canadian commercial equipment financing market has been through a material transformation. The sale of GE Capital companies has further redefined the commercial equipment finance market as well as distributed talented executives throughout the industry.

The pace of these changes has been rapid, and the full impact of the market share shifts is continuing independently and in addition to merger and acquisition activity. Time will tell if the decline of independent finance and foreign leasing company market share is permanent. Perhaps the most interesting part of the story of Canada's changing commercial equipment finance marketplace is how the next chapter will read.

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