Case Comment
Commentaire d'arrêt

SECURITIZATION AND FINANCIAL TRUTH

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Financial "truth" can be an elusive concept.[1] Consider consolidated financial statements. If a public corporation holds all the outstanding shares of an operating subsidiary, and that operating subsidiary has significant amounts of debt, is it "true" that those debts are debts of the parent corporation? As a matter of corporate law, shareholders are not liable for the debts of a corporation. That is the truth. But there is another truth. Accounting rules require a parent corporation to include the debts of its subsidiaries on its consolidated financial statements. Accounting "truth," then, is something different from corporate "truth."

As financial engineering becomes increasingly sophisticated, the simplistic notion that a corporation's "true" financial state can be readily and definitively determined is continually being challenged. It is often the very point of complex financial products to straddle ambiguities so as to benefit from concurrent legal characterizations. The nebulous border between debt and equity, for example, is nothing like the crisp court lines at Wimbledon. It is not so easy to determine whether a particular financial instrument is "in" or "out" of the equity box. Such fuzzy boundaries are known to judges, and well understood by investment bankers.[2] Many accounting and "tax efficient" (and tax-driven) strategies and structures have been sanctioned by Canadian courts, including the Supreme Court of

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[1] The question of defining financial "truth" in broader terms than mere compliance with generally accepted accounting principles has become significant in light of recently enacted requirements that certain senior corporate officers personally certify the accuracy of certain corporate disclosures. In the United States, see the *Sarbanes-Oxley Act of 2002*, s.302; Exchange Act Rules 13a-14, 15a-14. In Canada, see Multilateral Instrument 52-109, s. 2.1, Form 52-109F1.

[2] See the remarks of Justice Iacobucci in *Canada Deposit Insurance Corp. v. Canadian Commercial Bank*, [1992] 3 S.C.R. 558 at 590: "Financial and capital markets have been most creative in the variety of investments and securities that have been fashioned to meet the needs and interests of those who participate in those markets…. It is permissible, and often required, or desirable, for debt and equity to co-exist in a given financial transaction without altering the substance of the agreement."

Canada.[3] And if clever financial gymnastics are not unlawful, can it not be said that corporate officers and directors, duty-bound to increase their corporation's value, are not only permitted but actually obliged to explore the use of such devices?

One especially important class of GAAP-stretching structures are those that use "special purpose entities" to shift assets and liabilities off the balance sheet. The infamous Enron Corporation made particularly extensive use of off-balance sheet techniques,[4] prompting Congress to amend the *Securities Exchange Act of 1934* to enhance the obligations of issuers to disclose off-balance sheet techniques,[5] and to require the Securities and Exchange Commission (SEC) to complete a study of filings to determine, among other things, "the extent of off-balance sheet transactions," and "whether generally accepted accounting rules result in financial statements of issuers reflecting the economics of such off-balance sheet transactions to investors in a transparent fashion."[6]

It is not the purpose of this comment to analyse the U.S. accounting and regulatory initiatives that followed. It is interesting, however, that the SEC off-balance sheet report called for by the *Sarbanes-Oxley Act* explained that "when the Staff refers to the 'economics' of an arrangement, the reference is meant to speak generally to the risks, rewards, rights and obligations associated with the arrangement, rather than a formal categorization."[7] The SEC Staff, in other words, understood their task as a search for something like economic "truth." As they explained in the report:

> [R]ules-based standards can provide a roadmap to avoidance of the accounting objectives inherent in the standards. Internal inconsistencies, exceptions and bright-line tests reward those willing to engineer their way around the intent of standards. This can result in financial reporting that is inconsistent and not representationally faithful to the underlying economic substance of transactions and events. For example, with respect to securitizations, current standards allow issuers to structure transactions to achieve desired accounting results – that is, either sale or borrowing treatment for the items

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[3] See *Duha Printers (Western) Ltd. v. Canada*, [1998] 1 S.C.R. 795; *Neuman v. M.N.R.*, [1998] 1 S.C.R. 770; *Shell Canada Ltd. v. Canada*, [1999] 3 S.C.R. 622.

[4] Former Enron CEO Jeff Skilling insisted that Enron's use of off-balance sheet techniques was far from unique, telling a House of Representatives Committee that: "The off-balance sheet entities…that have gotten so much attention are commonplace in corporate America." Subcommittee on Oversight and Investigations, February 7, 2002.

[5] *Sarbanes-Oxley Act*, *supra* note 1, s. 401(a).

[6] *Ibid.*, s. 401(c)(1).

[7] Division of Corporate Finance, SEC, *Report and Recommendations Pursuant to Section 401(c) of the Sarbanes-Oxley Act of 2002 on Arrangements with Off-Balance Sheet Implications, Special Purpose Entities, and Transparency of Filings and Issuers*, June 15, 2005, at 45.

being securitized – for what are economically similar transactions.[8]

Most Wall Street (and Bay Street) creations are never challenged in the courts. Judges therefore rarely have occasion to struggle with such issues, except perhaps on those infrequent occasions when tax authorities are miffed that they have been outwitted by the financial engineers.[9] Little wonder, then, that the Canadian financial community followed with interest the recent decision of the Ontario Court of Appeal in *Metropolitan Toronto Police Widows and Orphans Fund v. Telus Communications Inc.*[10] The case marked the first time a Canadian court has been called upon to determine the legal nature of a securitization transaction.[11] The court was well aware of the potential effects of its decision. Justice Blair pointed out that "securitization has become increasingly popular" and involved "an aggregate of hundreds of billions of dollars of financing in the United States alone and over $26 billion in Canada."[12] Yet this important financial tool has depended upon an untested legal assumption, namely, that Canadian courts would accept that the transfer of securitized assets from the so-called "Originator" of these assets to a special purpose vehicle was for all purposes a true sale, and not something else (for example, an artfully disguised secured loan.).

To be sure, the Court of Appeal in *Telus* maintained that "this appeal is not truly about securitization."[13] Instead, the focus was upon the interpretation of language contained in a trust deed entered into several years before the impugned securitization transaction had been undertaken. The trust deed was actually drafted in 1985, before securitization had become a widely-used financial technique in Canada. Though mortgage securitization had existed since at least the 1970s,[14] and asset-backed (i.e.

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[8] *Ibid.* at 102.

[9] See *Shell*, *supra* note 3, where the Supreme Court was asked to rule on the tax effectiveness of an ingenious technique known as "weak currency financing" that had been developed to exploit the way in which interest expense and capital gains were treated for Canadian tax purposes. Though the taxpayer succeeded, the *Income Tax Act* was subsequently changed to block further use of the technique.

[10] (2005), 5 B.L.R. (4th) 251 (Ont. C.A.).

[11] At the date of writing, counsel had not ruled out the possibility of seeking leave to appeal to the Supreme Court of Canada.

[12] *Supra* note 10 at 255. The market is actually significantly larger than the $26 billion referred to in the judgment, a figure which was based on dated sources. In 2004, the Dominion Bond Rating Service reported that as of December 31, 2004 the total dollar amount of outstanding Canadian asset-backed securities was $101.7 billion, including new issuances of $9.8 billion in 2004 alone. See H. Loke & S. Bridges, *2004 Year-End Review of Canadian Asset-Backed Securities* (Dominion Bond Rating Service, 2005) at 1.

[13] *Ibid.* at 256.

[14] Mortgage securitizations had been completed in the 1970s by the Government

non-mortgage) securitizations since 1985,[15] the technique was still too exotic in 1985 to merit specific reference to such transactions in boilerplate contractual clauses. At its simplest, then, *Telus* usefully addressed one of the problems that keeps corporate lawyers awake at night. What will happen if we have missed something? Will general language work to cover off the possibility of some as yet undiscovered innovation?

Securitization

Securitization involves the transfer of financial assets from one party, the "Originator" (in the case of a receivables securitization, the party to whom the account debts were originally owed) to a corporation or trust that has been specially created to acquire and hold such assets (the Special Purpose Vehicle or SPV). The SPV pays for these assets by issuing securities, typically debt securities that have been structured so that they may receive a high rating from a credit rating agency. In Canada, the most frequently "securitized" financial assets have been mortgages. Residential and commercial mortgages together still comprise the largest percentage of the securitization market (about 29% of total securitized assets in 2004),[16] but auto leases and loans (23%) and credit card receivables (21%) have also come to represent a sizable share.[17] Though mortgages, auto leases and loans and credit card receivables account for most Canadian securitizations, the variety of assets that can be securitized by creative financial experts is almost limitless.[18]

Securitization works, and is valuable to an Originator, only because the Originator is able to remove (or "derecognize") the securitized assets from the left side of its balance sheet, and raise funds secured by those assets without incurring any additional liabilities on the right side. The securitization market was jump-started when bank capital rules were changed in 1988. Many banks found it expedient to securitize a portion of their assets so as to avoid the need to raise additional equity to ensure compliance with more stringent capital rules.[19] While off-balance-sheet treatment is fundamental to any securitization, the more specific financial advantages of a securitization vary from Originator to Originator. In the *Telus* case, for example, it appears that reduction of capital tax was a

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National Mortgage Association. See J. Shenker & A. Colletta, "Asset Securitization: Evolution, Current Issues and New Frontiers" (1991) 69 Tex. L. Rev. 1369 at 1384.

[15] It is generally acknowledged that the first asset-backed deal in the United States was Sperry Computer's 1985 securitization of computer leases.

[16] Loke & Bridges, *supra* note 12 at 3.

[17] *Ibid.*

[18] See C. Nicholls, *Corporate Finance and Canadian Law* (Toronto: Carswell, 2000) at 60.

[19] *Ibid.* at 63.

significant consideration.[20]

For most non-financial institutions, however, the prospect of obtaining lower capital market funding rates is the key advantage to a securitization transaction. Holding only a prime portfolio of financial assets, with no debts or liabilities other than the very instruments issued to facilitate the securitization, the SPV is typically a more credit-worthy borrower than the Originator itself. Moreover, securitization transactions typically include one or more forms of internal or external credit enhancement. Internal credit enhancement may take the form of over collateralization, for example, where the financial assets transferred to the SPV have a face value exceeding the amount advanced by the SPV to the Originator. Additional external credit enhancement (such as a letter of credit or perhaps a guarantee) may also be provided by a financial institution, making the securities issued by the SPV especially low risk. Further, the SPV can obtain debt financing directly from capital market investors, rather than through a bank or other financial intermediary. Accordingly, the cost of borrowing for the SPV may be materially lower than the Originator's cost of debt capital, and that lower borrowing cost is passed on to the Originator, either directly or indirectly.[21]

It is apparent that securitization bears some resemblance to a secured lending transaction. The Originator obtains capital that has been raised through the sale of debt instruments to investors. The payment obligations owed to those investors are essentially secured by a specific pool of financial assets. However, a securitization actually makes it possible to obtain lower borrowing rates than a traditional secured lending deal. In a secured lending transaction, the lender still bears the risk that the borrower, as it carries on an active business and incurs further debts and obligations, might become bankrupt or insolvent. Although senior secured lenders may expect to fare better in a bankruptcy than other claimants, even the highest ranking creditors are unlikely to recover the full value of their debts

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[20] See *Metropolitan Toronto Police Widows and Orphans Fund v. Telus Communications Inc*. (2003), 30 B.L.R. (3d) 288 at 298 (Ont. Sup. Ct.).

[21] Though it is easy to understand how securitization can make it possible for an SPV to raise funds in the capital markets, secured by a portion of the Originator's financial assets, at lending rates materially lower than those generally available to the Originator, some have nevertheless questioned how a securitization can effectively reduce an Originator's *total* borrowing costs. Since the transfer of the securitized assets will actually deplete the Originator's assets and therefore increase the risk of lending directly to the Originator, should this not mean that the Originator's other borrowing costs would actually increase? Would the increase in the Originator's remaining borrowing costs not offset any savings realized through the securitization transaction? For a variety of reasons, however, it appears that securitization can lower an Originator's overall cost of funding. See S. Schwarcz, "The Alchemy of Asset Securitization" (1994) 1 Stan. J.L. Bus. & Fin. 133.

without incurring some enforcement costs. In a securitization, the issuer of the debt (the SPV), is structured to be "bankruptcy remote," (that is, all but immune from the risk of becoming insolvent or bankrupt) and, critically, free from the risk of SPV assets being affected in the event of the bankruptcy or insolvency of the Originator.

Although bankruptcy remoteness is a fundamental attribute of a successful securitization, there has long been a nagging fear among some practitioners that a court might not accept the characterization of the typical transfer of securitized assets from an Originator to an SPV as a true sale. If that were to occur, the expected benefits of derecognition would melt away. Moreover, creditors of the Originator in a bankruptcy or insolvency proceeding could argue that the assets purportedly "transferred" to the SPV were, in fact, still assets of the Originator. Accounting rules and guidelines have been developed to clarify when, as an accounting matter, a securitization transaction will constitute a "true sale."[22] Accounting rules, however, are not determinative of legal issues, and a material risk that courts would reject the true sale characterization would be calamitous for the continued functioning of the securitization market.

Introductory descriptions of securitizations often use as the paradigm case a securitization consisting of a one-time transfer of assets from the Originator to the SPV. The SPV is presumed to purchase the assets from the Originator at some discount to their face value. This discount compensates the SPV for providing immediately available funds to the Originator in exchange for financial assets that will produce future cash flows over time. Securitizations can be considerably more complex than this simple paradigm, as the facts in *Telus* reveal. The increasing layers of complexity, coupled with the continuing role typically played by the Originator in "servicing" the securitized assets, obscures the traditional indicia of legal ownership, and so invites the question of how to characterize the "true" nature of the transaction.

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[22] In the United States, SFAS No. 140 deals with this question. The approach taken is referred to as the "financial components" approach. Recent work of the FASB on this issue is referred to in the SEC Staff Report, *supra* note 7 at 46, especially note 133. In Canada, the Accounting Standards Board (AcSB) has issued a guideline on securitization that according to the AcSB is "consistent with the requirements of SFAS No. 140 on this subject." The current guideline, applicable to transfers after June 30, 2001, was not in place at the time of the *Telus* transaction and although the AcSB had issued guidelines earlier in EIC-9 and EIC-54, these accounting statements would not be determinative of the legal treatment of such transactions and in any event were not referred to by either the trial judge or the Court of Appeal.

The Facts in Telus

BC Tel, the predecessor of Telus Communications Inc., had issued a series of first mortgage bonds in 1985. The bonds bore interest at the rate of 11.35% per annum, with interest payments to be made semi-annually. The bonds were to mature in 2005, but they could be redeemed by the issuer earlier than that upon payment to the bondholders of a premium specified in the trust deed. The bonds could not, however, be redeemed prior to November 15, 2000 "by the application, directly or indirectly, of funds obtained through borrowings having an interest cost to the Company of less than 11.35% per annum."[23] It was this restriction, the so-called "No Financial Advantage Covenant" (or "NFAC"), that was the focus of the case. The purpose of such a clause is clear. Without it, the purchasers of redeemable bonds would bear significant re-investment risk. An issuer would only redeem the bonds when market interest rates had fallen. If market interest rates were low, however, the bond investor would not be able to place the redemption proceeds it received in investments of similar risk at interest rates as high as those of the original bond issue.

To induce investors to purchase bonds in the first place, some assurance must be offered that their interests will be protected from such opportunistic redemptions by the issuer. At the same time, there could be many good reasons, unrelated to a fall in market interest rates, that might prompt an issuer to retire outstanding debt, and it would be unduly and inefficiently restrictive to forbid the issuer from ever doing so. If, for example, the issuer were suddenly flush with cash realized from a significant asset sale, it would legitimately need to retain the right to use that cash to redeem its bonds (upon payment to the bondholders of a modest premium), just as homeowners justifiably seek the option to prepay their mortgages in the event that they receive an unexpected cash windfall during the term of the mortgage. The BC Tel trust deed thus permitted the issuer to use the proceeds realized on a sale of assets to redeem outstanding bonds. But the NFAC prohibited redemption of the bonds through the direct or indirect application of funds obtained through lower-cost borrowings.

BC Tel redeemed the bonds in December 1997. Market interest rates at the time of the redemption were significantly lower than the 11.35% interest rate payable on the bonds. Since bond prices are inversely related to market interest rates, the outstanding bonds were trading at a significant premium immediately prior to the redemption.[24] Each $100 bond had a

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[23] *Supra* note 10 at 257.

[24] Bond interest prices are fixed at the time of their issue. Thus, if interest rates in the market generally fall after the bonds have been issued, the above-market interest payable

market price of about $115. The trust deed required, when the bonds were redeemed before maturity, that the issuer must pay the bondholders a redemption premium. The premium to be paid in December 1997, however, was about 3%, considerably less than the 15% premium at which the bonds were actually then trading. Accordingly, the bondholders lost approximately $12 per $100 principal amount of bonds as a result of the redemption. They were displeased. However, did they have valid legal grounds on which to contest the early redemption? Specifically, was the redemption permitted by the NFAC or not?

BC Tel had acquired the funds used to redeem the bonds by securitizing a rolling portfolio of its receivables. BC Tel was the "Originator" and a trust (RAC) was the SPV. As indicated earlier, in order to achieve its many presumed benefits, a securitization must be legally characterized as a "true sale" of the securitized assets by the Originator to the SPV, and not merely a disguised loan to the Originator. Accordingly, BC Tel argued that the proceeds it had realized in this securitization transaction, since they were proceeds from a sale of assets and not from a "borrowing," could properly be applied to redeem the bonds without offending the NFAC clause.

It was this aspect of the case that gave many commercial lawyers pause. If the court were to hold that this securitization was, in substance, a borrowing and not a true sale, then Bay Street bankers and their lawyers would have been sent scrambling to divine relevant legal distinctions between the Telus securitization deal and the billions of dollars worth of other outstanding securitization transactions, the viability of which depended upon a "true sale" characterization. Though there may have been relatively few cases in which disgruntled bondholders would attack redemptions funded by securitizations, a successful attack on the integrity of a typical securitization would have opened the door to other sorts of potentially more serious attacks. In particular, creditors of Originators threatened with bankruptcy or insolvency proceedings might well insist that if securitizations were merely camouflaged loans, and not true sales, any "securitized" assets would remain part of the Originator's estate.[25]

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on the bonds makes them more valuable. Hence bond prices rise. Conversely, if interest rates rise after the bonds have been issued, the below-market interest payable on the bonds makes them less valuable. Hence bond prices fall.

[25] The spectre of such a disaster had been raised some years ago by at least one American academic critic of securitizations. See D. Carlson, "The Rotten Foundation of Securitization" (1998) 39 Wm. & Mary L. Rev. 1055. Carlson's argument, strictly speaking, does not turn on whether the conveyance of securitized assets would be regarded as a true sale.

The Trial Decision

At trial, Justice Ground categorically dismissed any suggestion that the redemption of the bonds was improper. The NFAC proscribed redemptions only if they were undertaken through the direct or indirect application of borrowed funds, and in his view, the redemption was not funded by borrowings at all. He cited with approval an earlier judicial observation that the reference to "indirectly" in such NFAC covenants refers to instances, "in which the underlying economic reality of the completed transaction is the functional equivalent of a direct loan for purposes of effectuating a redemption and nothing more."[26] Justice Ground concluded that because the securitization "was not approved strictly for the purpose of using the proceeds to redeem the Bonds," it was not an indirect borrowing by BC Tel.[27]

Much time was then devoted by the trial judge to the question of whether or not the securitization was, in fact, a *direct* borrowing by BC Tel. It was that analysis, left undisturbed by the Court of Appeal, where the "true sale"/loan characterization was tackled. The analysis was complicated because the securitization did not simply involve a discrete transfer of a fixed portfolio of receivables. Rather, it involved the common (though sophisticated) transfer of a revolving pool of receivables. Put simply, BC Tel was continually transferring new receivables to the SPV and "retiring" old receivables. Accordingly, the SPV did not merely make a one-time payment to BC Tel, but rather made a regular series of purchases of "Eligible Receivables." Only "Eligible Receivables" could ever be "Purchased Receivables." A receivable might be an "Eligible Receivable" in accordance with the agreement on one day, but not an "Eligible Receivable" the next. The SPV might purchase a particular receivable on Monday, transfer it back to BC Tel on Tuesday, then repurchase it from BC Tel on Wednesday, and so on.[28] These back-and-forth transfers happened, as it were, automatically. In the language of the agreement, quoted by the trial judge: "[The Agreement] provides that RAC purchases from BC Tel and BC Tel sells, assigns and transfers to RAC, all of BC Tel's right, title and interest in and to 'the universality of all Eligible Receivables which, from time to time, constitute Purchased Receivables and all Related Security, all without the need of any formal or other instrument of assignment.'"[29] The parties had essentially decreed by contract that this seamless series of transactions, evidenced by no additional formalities, constituted a continuous series of sales. Of course,

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[26] *Supra* note 20 at 298.
[27] *Ibid*.
[28] *Ibid*. at 292.
[29] *Ibid*.

these shifts in ownership would be invisible to the account debtors themselves because BC Tel, as is typically the case in receivables securitizations, continued to "service" the receivables for RAC. From the perspective of the debtors whose accounts had been transferred, no evident change had occurred. They would continue to be billed by BC Tel, blissfully unaware that under the terms of the securitization, BC Tel was collecting those payments as agent for the new "owner" (RAC) of the accounts. The expressed contractual intention of BC Tel and RAC was that these transactions should be considered sales. No other characterization would achieve the benefits each party desired. As Justice Ground put it, "both parties could only get the full benefit of the transaction if it was a true sale. It was the intention of both BC Tel and [the SPV] that the transaction be a true sale and the conduct of the parties does not clearly and unequivocally negate that intention."[30]

That analysis offered considerable comfort to corporate solicitors. As long as a contract is carefully crafted, it appears the court will accept the legal characterization described by the contractual language absent conduct that "clearly and unequivocally" contradicts the language of the contract. To traditionalists, this may seem to reflect nothing more than the incontrovertible proposition that, unless there are exceptional circumstances, the court ought to give effect to the intentions of the contracting parties. The trial judge did in fact refer to the need to determine the parties' intentions, as embodied in the words of the contract itself, and in the absence of actions that flagrantly belied the ostensible contractual intention. Yet, on one reading of the trial judge's reasons, the "intentions" appear to be closely linked to the aspirations of the parties. It is clear that BC Tel and the SPV fervently hoped that, if challenged, a court would treat their transaction as a true sale. But to what extent does such desire for a particular legal characterization prove "intention" in the legal sense? It is tautologous to say that a contracting party will prefer the legal treatment for which he or she is arguing. Surely the question is whether or not the fundamental economics of the relationship constitute what, in law, is recognized as a sale. The appellant raised the issue on appeal. The Court of Appeal concluded that, in assessing the intentions of the parties, the judge "did not place too much emphasis" on this desirability factor.[31]

Justice Ground concluded that the securitization did not in substance amount to a borrowing despite his findings surrounding the form of monthly payment made by BC Tel to RAC throughout the term of the agreement. The monthly payment was referred to in the relevant agreement as a Purchase Discount, a name suggesting a reduction in the purchase

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[30] *Ibid*. at 291.

[31] *Ibid*. at 301.

price paid by RAC for the securitized receivables. Justice Ground held, however, that "Purchase Discount" was "a particularly inappropriate misdescription," since "[i]t is clearly not part of the purchase price...and it is certainly not a discount from the purchase price."[32] Somewhat curiously perhaps, given his ultimate decision, Justice Ground rejected the distinction the defendant had attempted to draw between genuine interest and this Purchase Discount. He characterized the Purchase Discount as "strictly a flow through to BC Tel of the interest cost payable by RAC on borrowings made by it through the issuance of commercial paper."[33] That finding did not deter him from concluding that the securitization was not an indirect borrowing.

In the result, Justice Ground held that the securitization was neither a direct nor an indirect borrowing and, accordingly, proceeds realized from the securitization could properly be applied to redemption of the bonds without offending the NFAC clause. The plaintiffs had also alleged that the redemption of the bonds, even if technically permitted by the trust deed, constituted oppression under s. 241 of the *CBCA*. Justice Ground rejected this claim as well, and his decision on that point was not appealed.

The Court of Appeal Decision

The Court of Appeal reversed the trial decision, finding that redemption of the bonds by BC Tel was achieved with funds indirectly obtained through borrowing and at an interest cost of less than 11.35%, and therefore contravened the NFAC.[34] Crucially, however, the Court of Appeal did not disturb the trial judge's conclusion that the transfer of the receivables was a true sale and therefore not a *direct* borrowing. Put crassly, the good fortune of the bondholders did not ultimately come at the expense of the future of the Canadian securitization market.

The key to the Court of Appeal's analysis was its holistic approach to the securitization transaction. Securitization, the court asserted, was "a hybrid phenomenon: it is part sale (the originating company transfers its assets to the SPV) and part borrowing (the SPV borrows money from the public through commercial paper issued on the security of the transferred assets)."[35] Nevertheless, in the court's view, it would be misleading to artificially bifurcate the individual elements of the transaction. The sale of receivables, even though a true sale, was not undertaken in a vacuum. Indeed, there would never have been a receivables sale except in the

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[32] *Ibid*. at 299.

[33] *Ibid*.

[34] *Supra* note 10.

[35] *Ibid*. at 260.

context of a securitization of which the borrowing by the SPV was an integral part. As the court explained, the sale and borrowing characteristics of a securitization "cannot be isolated one from the other in considering whether the proceeds of the transaction, as applied to redeem the Bonds, constitute funds obtained indirectly through borrowings."[36]

In its discussion of the true sale issue, at times the Court of Appeal suggests that it is merely affording a higher degree of deference to that aspect of the trial judge's decision (more akin to a finding of fact than a finding of law) than was appropriate to other findings by the trial judge in which the legal component of a matter dominated the factual issues.[37] In at least one portion of the judgment the Court of Appeal appears to be satisfied as to the actual correctness of the finding, saying: "[I]n the end I am satisfied that his characterization of the Receivables Purchase Agreement as a 'true sale' of the BC Tel accounts receivable to RAC Trust was correct. Like the trial judge, I find the lack of any right of redemption in the receivables on the part of BC Tel to be particularly compelling."[38] A finding that the transfer of the receivables was *not* a true sale would certainly have been fatal to the respondent's position; the transfer in such a case would constitute a direct borrowing in contravention of the NFAC clause. But a finding that it *was* a true sale did not end the inquiry because the NFAC also applied to indirect borrowings. BC Tel had not simply decided to sell its receivables to RAC; it had "entered into…*a securitization transaction* and not simply *a sale of assets*."[39]

The court considered it disingenuous of the defendant to suggest that the sale of receivables was a discrete sale of assets unrelated to the particular method RAC used to finance the purchase price:

> In my view, it is not open to BC Tel to say now – *vis-à-vis* its Bondholders – 'We only sold our assets to RAC Trust and used the proceeds to redeem your bonds. How RAC Trust raised the monies to pay the purchase price is no concern of ours, or yours.' BC Tel knew that it was engaging in a transaction, with the accompanying benefits outlined above, the ultimate effect of which was that monies raised through commercial paper borrowings from the public would flow into its hands.[40]

The Court of Appeal entertained little doubt that this securitization, considered in its entirety, constituted an indirect borrowing within the meaning of the NFAC clause, notwithstanding that the funds raised had

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[36] *Ibid*. at 265.
[37] *Ibid*. at 261-62.
[38] *Ibid*. at 264.
[39] *Ibid*. at 265.
[40] *Ibid*. at 266.

been borrowed by BC Tel itself.[41] Justice Blair gave short shrift to the trial judge's reasoning that a transaction could be considered an "indirect borrowing" only if undertaken for no reason other than to redeem the bonds, and further, if it had "no independent economic function" to either BC Tel or RAC. Such a conclusion, reasoned Justice Blair, echoing submissions of the appellant, "might well 'permit a party to neuter and render ineffective a covenant of this sort merely by including a marginal collateral benefit in a transaction in which the company indirectly obtains cheaper funds.' This could not be the intention of the NFAC."[42] The Court of Appeal had no difficulty in concluding that the Purchase Discount represented an interest cost to BC Tel within the meaning of the NFAC clause, denouncing as "sophistry" any suggestion to the contrary.[43]

The Court of Appeal's integrated approach to assessing the BC Tel securitization transaction resonates with common sense, and echoes a response to what has been called the "unit of account problem." As explained in the SEC report:

> This structure also highlights what is referred to by accountants as the "unit of account" problem. The economics of a transaction may look quite different depending on how broadly or narrowly one defines the boundaries of the transaction. That is, a particular contract may appear to have certain economic characteristics when viewed in isolation – and may be given a certain accounting treatment that corresponds to those economic characteristics – but if understood as a piece of a larger agreed-upon transaction may actually have quite different economics, and be properly accorded different accounting treatment. Thus, determining the actual bounds of a transaction is fundamental to understanding both the underlying economics and the proper accounting treatment. Determining these bounds has been and will remain an ongoing challenge to standard setters, auditors, and regulators.[44]

Notwithstanding the overall soundness of the court's conclusion, it does raise some thorny questions about the nature of financial truth. Why, for example, are some consequences of respecting the apparent "intention" or desire of contracting parties to be privileged over others? If the transfer of securitized receivables was indeed a "true sale," then why should the bondholders not have to accept that consequence? Alternatively, if it seems strained, or indeed "sophistry" to deny that the securitization amounted to an indirect borrowing, why, then, is it any less strained to permit BC Tel to enjoy the capital tax reduction and other benefits flowing from its preferred characterization? Why, in short, is it any less logical or reasonable to

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[41] *Ibid*.

[42] *Ibid*. at 269.

[43] *Ibid*. at 270.

[44] *Supra* note 7 at 19.

consider the "central economic function of the 'integrated single transaction'"[45] for these purposes? Is the answer that the bondholders in this case were innocent third parties deserving of the court's protection (and not, as in the case of taxing authorities, parties with the ability to have a statute amended to protect their interests in the future)? Such an answer, however, leaves the question of "financial truth" at best relativistic, and at worst, indeterminate.

Conclusion

The end result in the *Telus* case does seem to accord with what the parties themselves might reasonably be expected to have bargained for had securitization been contemplated at the time the trust deed was signed. Judges can hardly be faulted in commercial disputes when they reach the result that the parties themselves would have provided for contractually had they directed their minds to the matter in question. The judicial route to this result was a generous, but by no means strained, interpretation of the vague but serviceable adverb "indirectly." It is constructively ambiguous catch-all words like this that allow lawyers to bring all-night drafting sessions to an end. Such language *should* be expected to catch the unexpected, just as the Court of Appeal held in this case.

As a matter of contract interpretation, then, the Court of Appeal arguably reached the right result. The parties "intended" the transaction to be regarded as a sale, and the court accepted that characterization, without allowing it to defeat the broadly-drafted contractual prohibitions against "indirect" borrowings. One might even suggest that the court's holding may help to facilitate financial innovation on two levels. First, by upholding the basic premise upon which securitization is based, it provides comfort to financial engineers and therefore will not deter useful financial innovation. Second, by avoiding a narrow construction of "catch all" contract language, the court has again provided some comfort that contracts may be made under conditions of uncertainty without imposing upon the parties the wasteful (and futile) expense of attempting to provide in detail for every future state of the world.

Still, it is difficult to ignore the malleability of "truth" that the case reveals. An awareness of such financial malleability should give us pause as we judge business decision-makers, and as we look to define, strengthen and uphold standards of transparency and honesty in financial reporting in the wake of the financial scandals of the past several years. "Beauty is truth," according to Keats, and truth, like beauty, is often in the eyes of the beholder.

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[45] *Supra* note 10 at 268.