JUNE 2015

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Blaneys on Business Bulletin

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This newsletter is designed to bring news of changes to the law, new law, interesting deals and other matters of interest to our commercial clients and friends. We hope you will find it interesting, and welcome your comments.

Feel free to contact any of the lawyers who wrote or are quoted in these articles for more information, the editor, or the head of our Corporate/Commercial Group:

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NEW TAX RULES FOR SPOUSAL TRUSTS COULD HAVE SEVERE CONSEQUENCES: REVIEWS OF WILLS STRONGLY ADVISED

Margaret E. Rintoul

New tax rules for all trusts, including spousal trusts which have often been set up to protect the inheritance of the children from a prior relationship and, at the same time, provide for a second spouse, or to allow for a degree of income splitting, take effect next January 1.

As a result, many of the reasons for spousal trusts in the past are no longer effective. In fact there will be consequences that were totally unexpected.

Anyone with a will that creates a spousal trust, therefore, is strongly advised to review it, and the reasons for it, to make sure that it does not create new, unanticipated and unintended implications.

Here is a scenario to help explain what has happened:

Tom and Carol were each divorced with children from their respective prior marriages. They got married to each other 20 years ago. After their marriage Tom had a will drawn up and in it created a spousal trust in which his assets were left in the trust with the income from those assets left to Carol for the rest of her life and the capital going to his children on Carol's death. Carol did a similar will leaving her assets, which were less than Tom's, in trust for Tom during his lifetime and the capital to her children.

Then Tom died and Carol became the beneficiary of the spousal trust created in Tom's will. The income that the spousal trust earned was paid to Carol, but part of it was taxed in the trust at marginal rates and part was taxed in Carol's hands at her marginal rates so that none of the income was taxed at the maximum marginal rates.

Starting January 1, however, any income taxed in the spousal trust will be taxed at the maximum marginal rate. Income taxed in Carol's hands will be taxed at her marginal rates, so there will be no effective way to reduce the overall tax rate on the income from the trust.

And that is only one impact of the new rules.

When Carol ultimately dies, the assets in the spousal trust will be distributed to Tom's children, whose inheritance the trust was set up to protect. That distribution of capital will be tax free.

However, on Carol's death, all of the assets are deemed to be sold at their then market value and any capital gains from the point where they were acquired by Tom or since are taxable.

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"In many cases where spousal trusts have been the planning vehicle of choice, one spouse has substantial assets and wants to preserve their capital value for his or her children from a first relationship, while making proper provision for a second spouse."

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If the trust has $ 1 million in assets, for the sake of discussion, and $300,000 of those assets constitute a capital gain, half that gain, or $150,000, will be subject to tax. Historically, the tax was the obligation of the spousal trust which housed the capital assets, or the beneficiaries who received the capital assets, and had nothing to do with Carol personally or Carol's estate.

No longer.

Under the new rules, Carol's own estate assumes the obligation, with the spousal trust's taxable capital gain amount added to her other income in the year of her death. That means that Carol's children, who are to inherit her estate pay the price because the amount of money available to them from Carol's estate is diminished by whatever taxes are owed through the spousal trust.

For years, spousal trusts in wills have been used to defer capital gains, reduce Estate Administration Tax (by ensuring that assets held in trust in one estate and not passing outright to the survivor are only subject to one round of Estate Administration Tax on the death of the first spouse), and provide for some degree of income splitting.

In many cases where spousal trusts have been the planning vehicle of choice, one spouse has substantial assets and wants to preserve their capital value for his or her children from a first relationship, while making proper provision for a second spouse.

The shifting of the spousal trust's tax liability to Carol's estate in the example above could create a significant windfall for the capital beneficiaries of the trust (Tom's children), who will get the trust assets free and clear of tax.

At the same time, there could be a major hardship for Carol's beneficiaries, namely her children, who were to have inherited whatever assets belonged to Carol but whose inheritance will now be reduced or possibly eliminated because of tax owed on capital gains generated in the spousal trust.

The overall result of the change in tax liability may have been an error or oversight on the part of the tax department, which also introduced other similar changes relating to alter ego and joint partner trusts, where the result makes sense.

However, there has been another federal budget introduced since these changes were passed into law late last year and nothing has been done to fix this result. So, for the moment, it appears to be up to Canadian taxpayers, as far as possible, to arrange their affairs to take account of this new situation.

There are ways that can be considered as a means of making the overall result fairer, but they will require changes to existing wills that establish spousal trusts.

For trusts that are already being administered, it may not be possible to vary them in a way that will avoid this consequence when the spouse/beneficiary dies. ■

"The courts in Ontario and Delaware have decided who is to be paid what from the more than $7.1 billion available to meet creditors' claims in the Nortel Networks insolvency..."

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AT DAY'S END, NORTEL BANKRUPTCY JUDGES LAND ON WHAT IS FAIR AND REASONABLE

Lou Brzezinski

The courts in Ontario and Delaware have decided who is to be paid what from the more than $7.1 billion available to meet creditors' claims in the Nortel Networks insolvency, closing the 120-year-old book on Canada's first global research, development and technology enterprise.

Nortel filed for bankruptcy protection in January, 2009. The proceedings involved thousands of hours of detailed argument.

Ultimately, however, the courts ignored the representations of the various stakeholders, including arguments of legal ownership, equitable contribution, application of the Master Research and Development Agreement (MRDA) and contribution of intellectual property, to make what they considered to be a fair and just order in the circumstances.

The order, issued on May 12, 2015, addressed the allocation of the proceeds of the sale of all of Nortel's assets (most significantly, its intellectual property) and was placed in a notional "Lockbox" awaiting court order regarding distribution and allocation.

The claimants in the Nortel insolvency were divided as follows:

1. The Nortel Group - These were the parent corporation, Nortel Corporation, and the related and subsidiary corporations of the parent, including its U.S. subsidiaries and European subsidiaries.
2. Bond Holders - These bonds were issued by the Canadian Nortel Corp. and guaranteed by the U.S. subsidiaries.
3. The employees and retirees of Nortel Corp.

The dispute was not as to priority, but rather as about allocation of the proceeds in the Lockbox. The Nortel Group argued that, since it owned the assets that were sold, it was entitled to the majority of the funds distributed. There was in-fighting amongst the Nortel Group.

The U.S. subsidiary indicated that it had advanced the greatest amount of cash and so was entitled, by way of beneficial interest, to the greatest amount of fees to be distributed to the Nortel Group.

Nortel Corp. in Canada simply argued that it was the owner of all the assets which were distributed and hence was entitled to the majority of the distribution.

The European divisions of Nortel indicated that they contributed significant research and development which provided the most substantial value to the assets that were sold.

The bond holders indicated that their rights to receive payment derived from the entitlement of Nortel Corp., which bonds were, in fact, guaranteed by the U.S. subsidiary. In effect, their claims were derivative of Nortel Corp. and they felt that they would be entitled to the same distribution as Nortel.

The claimants and retirees indicated that since all creditors were unsecured, they needed to be treated the same in respect of the monies in the pot,

"The most substantial portion of the proceeds received from the sale of assets came from the intellectual property (IP) of Nortel Corporation."

and that their claims should rank proportionately with those of the bond holders and the Nortel Group.

The most substantial portion of the proceeds received from the sale of assets came from the intellectual property (IP) of Nortel Corporation. The employees argued that since they were the inventors of much of this IP, it would be inequitable and unjust not to be able to share in the distribution of these proceeds simply because the patents were registered in the name of Nortel Networks Corporation.

In that regard, the employees sought a portion of the proceeds under the doctrine of unjust enrichment.

Mr. Justice Frank J.C. Newbould of the Ontario Superior Court of Justice agreed that Nortel Networks would be unjustly enriched by receiving all the proceeds of the sale of the Nortel IP, at the expense of the creator/inventor employees who contributed to the creation of the IP, simply because the patents were registered in Nortel Network's name.

The Master Research and Development Agreement (MRDA)

Research and development was the primary driver of Nortel's value and profit. The residual profits of Nortel emerged only after fixed rate-of-return payments were made to all the various Nortel subsidiaries who contributed to the research and development under the MRDA in accordance with a residual profit-split method based on each entity's expenditure on research and development relative to the research and development expenditure of all associated companies.

Nortel Corp. argued that the MRDA should be the template for the distribution of the proceeds.

The court reviewed exhaustively all of the provisions of the MRDA. The court further engaged in an analysis of Canadian contract law dealing with the factual matrix surrounding the making of a contract. The court also considered the purpose for which the MRDA was created, which was simply a method of splitting profits or losses on a tax efficient basis while Nortel operated as a going concern. The court considered that the agreement was intended to apply only to Nortel while it operated and not to deal with rights after Nortel and its subsidiaries stopped operating its business. Hence, the MRDA was disregarded by the court as the allocation mechanism.

The Jurisdiction of the Court Under the *Companies Creditors Arrangement Act (CCAA)*

Mr. Justice Newbould addressed the principles that should be applied to determine the allocation of the proceeds. He pointed out that a court has wide powers in a *CCAA* proceeding to do what is just in the circumstances. Section 11.1 provides that a court may make any order it considers appropriate in the circumstances, and thereafter, Mr. Justice Newbould relied extensively on the decision of *Century Services Inc. v. Cannon (Attorney General)* 2010 SCC ("***Century***") and concluded after reviewing the case that,

> "The court has a broad, inherent jurisdiction to make orders as required to fill in gaps or lacunae not covered by specific provisions in the *CCAA*. As a court of general jurisdiction, the Superior Court of Justice has all the powers that are necessary to justice between the parties. Except where provided specifically to the contrary,

"In order to achieve pro rata allocation, the court dealt with the argument that to do so would constitute substantive consolidation (in which the various Nortel companies, taken together, would be regarded as one big business)."

> the court's jurisdiction is unlimited and unrestricted in substantive civil matters".
>
> "Given what the courts said in *Century* at paras 57 and 61, that the *CCAA* is skeletal in nature and does not contain a comprehensive code that lays out all that is permitted, that the incremental exercise with judicial discretion with respect to the *CCAA* has been adopted and has evolved to meet contemporary business and social needs and that when large companies encounter difficulty and reorganizations become increasingly complex, *CCAA* courts have been called upon to innovate accordingly".

Mr. Justice Newbould went on to say that it was a fundamental tenet of insolvency law that all debts should be paid *pari passu* (at the same rate) and that all unsecured creditors should receive equal treatment. He thereafter directed a *pro rata* (proportional) allocation as amongst all the creditors.

Substantive Consolidation

In order to achieve *pro rata* allocation, the court dealt with the argument that to do so would constitute substantive consolidation (in which the various Nortel companies, taken together, would be regarded as one big business). The U.S. Nortel claimants argued that this is impermissible under Canadian law. The court did not agree with this assertion, indicating that the funds realized from the sale of the proceeds that were in "the Lockbox" which was held on behalf of 38 Nortel debtor entities. This did not constitute substantive consolidation.

Thereafter, the court went on to state in obiter (opinion that does not constitute precedent) that substantive consolidation as a concept can be the subject matter of orders in both a bankruptcy proceeding and a *CCAA*. The court has the jurisdiction to do so on the basis of equitable jurisdiction. Mr. Justice Newbould relied on the decision of Mr. Justice Trainor in the case of *Re Northland Properties Ltd.* 69 CBR 266 and stated that by consolidating various estates, the court recognizes that certain creditors may be prejudiced as a result of same, with the main question being as to whether creditors will suffer greater prejudice in the absence of consolidation than the debtors will suffer from its imposition.

Mr. Justice Newbould adopted the seven factors in respect of substantive consolidation as follows:

1. Difficulty segregating assets.
2. Presence of consolidated financial statements.
3. Profitability of consolidation at a single location.
4. Comingling of assets and business functions.
5. Unity of interest and ownership.
6. Existence of inter-corporate loan guarantees.
7. Transfer of assets without observance of corporate formalities.

Conclusion

At the end of the day, the court ignored the arguments from the various stakeholders, including arguments of legal ownership, equitable contribution, application of the MRDA and the contribution of intellectual property to make what the court considered to be a fair and just order in the circumstances.

A complex and sophisticated series of legal arguments, long and complex facts and teams of

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"... arising from section 8 of the Interest Act ... interest-escalation provisions, late payment charges and default fees included in any debt instrument secured by a mortgage on real property are simply unenforceable in certain circumstances."

lawyers ultimately led the court to the conclusion to do what was fair and just -- to divide the money amongst all the stakeholders on a pro rata basis.

Credit should be given to the time and energy spent by both our Canadian courts and the courts in the U.S. in sifting through all these issues and coming up with what they considered to be the right and fair thing to do. ■

ONTARIO COURT OF APPEAL *INTEREST ACT* DECISION HAS LESSONS FOR BOTH LENDERS AND BORROWERS

Kym Stasiuk

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The Ontario Court of Appeal has delivered important messages to lenders who take mortgages on real property as security and to borrowers who provide such security.

Those messages are contained in the Court's recent decision in *P.A.R.C.E.L. Inc. v. Acquaviva* (2015 ONCA 331).

Chief among them is a caution, arising from section 8 of the Interest Act, that interest-escalation provisions, late payment charges and default fees included in any debt instrument secured by a mortgage on real property are simply unenforceable in certain circumstances.

In the business world of money lending, other than rates that exceed the criminal rate of 60 per cent per annum, lenders and borrowers are free to negotiate and agree on any rate of interest applicable to a loan.

If the loan goes into arrears, often a lender will have in place in the loan contract a requirement for the borrower to pay a substantially higher interest rate, sometimes known as an interest escalation provision. This clause is recognized as a legitimate and effective way to ensure the prompt repayment of the loan.

When it comes to mortgage loans, however, a different rule comes into play. As a movie director might say, cue section 8. This section prohibits lenders from levying fines, penalties or rates of interest on any arrears of principal or interest that are secured by a mortgage on real property and that have the effect of increasing the charge on the arrears beyond the rate of interest payable on principal money not in arrears.

While recognizing the general notion that parties are entitled to freedom of contract, section 8 is intended to protect property owners against abusive lending practices. For example, the courts have recognized that if an owner of real estate were already in default of payment under the interest rate charged on monies not in arrears, a still higher rate, or greater charge on the arrears would render foreclosure all but inevitable, thereby making it impossible for owners to redeem or protect their equity.

The *P.A.R.C.E.L. Inc. v. Acquaviva* decision takes an interesting look at the circumstances that trigger section 8.

In this case, Acquaviva loaned P.A.R.C.E.L approximately $500,000. The repayment of the loan was secured by a promise to pay set out in a promissory note. The note was secured, in turn, by a mortgage on real property in the same amount.

The interest rate set out in both the mortgage and the note was 0.75 per cent per annum. Unlike the

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mortgage, however, the note contained an interest escalation provision whereby the interest rate was increased to 10 per cent after default.

The mortgage also provided that Acquaviva would be entitled to a late charge of $10 per day in the event of their late receipt of monthly payments due under the mortgage and payment of a $300 "Missed Payment Fee" if payments under the mortgage were missed.

On a motion for summary judgment, the motion judge awarded Acquaviva interest at the rate of 10 per cent, rather than 0.75 per cent, per annum along with significant late payment charges and default fees.

Included in the grounds of appeal, of course, P.A.R.C.E.L raised the issues that the provisions in the note and mortgage that set out both the 10 per cent interest rate and the late payment charges and default fees violate section 8 of the Interest Act. The Court of Appeal agreed with P.A.R.C.E.L on both grounds.

In finding that section 8 applies to the single loan secured by both the note and the mortgage, the Court said it was not necessary that the mortgage contain a provision that payment of the note constitutes payment of the mortgage or vice versa. The Court also did not see the need for commonality between the parties to the note and the parties to the mortgage (that they be one and the same) since the debt owed under both the note and the mortgage was the same.

The Court said that section 8 applies regardless of which debt instrument contains the prohibited charges and that where the debt is secured by a note that is itself secured by a mortgage, each for the same principal amount, and where payment of one is payment of the other, but where each contains different terms regarding post-default interest, the terms of the note determine the rate.

With respect to the late payment charges and fees, the Court said that in the absence of evidence that the charges in question reflect real costs legitimately incurred by Acquaviva for the recovery of the debt, in the form of administrative costs or otherwise, the only reason for the charges was to impose an additional penalty or fine, apart from the interest otherwise payable under the mortgage, thereby increasing the burden on P.A.R.C.E.L beyond the rate of interest agreed upon in the mortgage. The late payment charges and default fees were therefore found to violate section 8 of the Interest Act and were disallowed by the Court.

The takeaways from the case, from this writer's perspective, are threefold.

First, to avoid costly litigation, it is obviously very important that the repayment provisions contained in debt instruments that secure repayment of the same mortgage loan are consistent.

Second, if there are conflicting rates of interest on default with respect to the same loan under both a mortgage and a promissory note secured by such mortgage, the terms of the note determine the applicable rate.

Finally, as indicated earlier, both lenders and borrowers should take heed of section 8 of the Interest Act and be aware that interest-escalation provisions, late payment charges and default fees included in any debt instrument secured by a mortgage on real property that have the above described effect are simply unenforceable. ■

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