APPENDIX A

THE COMMERCIAL LAW STRATEGY

UNIFORM LAW CONFERENCE OF CANADA/LAW COMMISSION OF CANADA JOINT COMMITTEE ON HARMONIZATION OF THE FEDERAL BANK ACT SECURITY AND THE PROVINCIAL SECURED TRANSACTIONS REGIMES

and

THE STUDY COMMITTEE ON THE REFORM OF CANADIAN SECURED TRANSACTIONS LAW

PAPERS ON HARMONIZATION

The aim of the Commercial Law Strategy is to modernize and harmonize commercial law in Canada, with a view to creating a comprehensive framework of commercial statute law that will make it easier to do business in Canada, to the benefit of Canadians and the economy as a whole. The Strategy has identified two areas that appear to be particularly in need of reform. The first concerns the problems of interaction between the federal Bank Act security device and the provincial secured transactions regimes. The second involves the disparity in the rules among provincial and territorial systems dealing with security interests and hypothecs.

To address the issue of interaction between federal law and that of the provinces and territories, the Law Commission of Canada and the Uniform Law Conference of Canada have undertaken a joint project on the harmonization of the federal Bank Act security and the provincial and territorial secured transaction regimes. In addition, the Uniform Law Conference of Canada has undertaken a project on the harmonization of provincial and territorial secured transactions law. To address these issues the Uniform Law Conference of Canada has established a Study Committee on the Reform of Secured Transactions Law. The Study Committee will report back to the Law Commission of Canada and the Uniform Law Conference of Canada with recommendations with respect to the Bank Act.

The Study Committee will also report back to the Uniform Law Conference of Canada on the reform of the provincial and territorial legislation.

The Committee has examined several aspects of these issues with a view to determining whether a greater degree of harmonization is possible and, if so, what approach should be taken to achieve it. Before reaching any conclusions that will be the basis for recommendations to the Uniform Law Conference and the Law Commission of Canada, the Committee wishes to get as much guidance as possible from members of the legal profession and from those affected by the operation of the law in these areas. To that end, a large number of people and organizations involved in secured financing in Canada will be contacted, primarily by way of electronic communication, to solicit their response to a series of questionnaires developed by the Study Committee. The Study Committee has produced background papers to accompany each of the questionnaires. Individuals responding to the questionnaires are strongly encouraged to consult the background papers to assist them in providing an informed response to the issues addressed.

BACKGROUND PAPER 1: **Priority Competitions Between Bank Act Security and Provincial or Territorial Security Interests**

BACKGROUND PAPER 2: **Priority Competitions Involving Proceeds of Inventory: PMSI Inventory Financers *vs.* Accounts Financers**

BACKGROUND PAPER 3: **Facilitation of Cross-border Secured Financing: Harmonizing Choice of Law Rules on Security in Movable Property**

BACKGROUND PAPER 4: **Anti-assignment Clauses Affecting Receivables and Chattel Paper**

BACKGROUND PAPER 5: **Security Interests in Licenses**

BACKGROUND PAPER 1

HARMONIZATION OF THE FEDERAL BANK ACT SECURITY AND THE PROVINCIAL SECURED TRANSACTIONS REGIMES

I. BACKGROUND

All Canadian provinces and territories have enacted statutory secured transactions regimes that comprehensively govern the validity, publicity, priority and enforcement of security rights in personal property and moveables. But not all forms of security interests are exclusively governed by these provincial statutes. Sections 427 to 429 of the *Bank Act* provides a federal personal property security regime. This regime is more restricted in scope than the provincial systems. A Bank Act security can only be given to a bank. Only certain categories of borrowers are eligible to grant the security, and the security can be given only in respect of certain categories of assets.

The original reason for the enactment of a federal secured transactions regime was that banks were prohibited from taking security rights in personal property or moveables to secure their loans. In order to promote the granting of credit to certain vital sectors of the economy, such as farming, fishing and forestry, the Bank Act provided that a special form of security (commonly referred to as Bank Act security) could be given to a bank.

Prior to the enactment of modern provincial secured transactions legislation, it was accepted that the Bank Act security device played a valuable role in the Canadian economy. The Bank Act security regime provided a number of innovative features which, in many ways, made it a better security device than the devices available under provincial law. Although the prohibition against a bank taking security was lifted in 1967, the Bank Act security proved popular with banks, and continued to be used extensively.

This state of affairs underwent a significant change upon the enactment of modernized secured transactions legislation by the provinces. This legislation thoroughly modernized the law and facilitated the granting of secured credit. It was no longer the case that provincial security agreements were viewed as an inferior form of security device. Indeed, many banks began to rely upon provincial security agreements as their primary form of security. In part, this was due to the fact that a provincial security right could be taken on all present and after-acquired personal property or moveables of the debtor (whereas the Bank Act security could only be given in specific types of tangible assets) and because of the more powerful remedies available (such as the power to appoint a receiver-manager).

One of the goals of modern secured transactions legislation was to bring greater certainty and predictability to the resolution of priority competitions. Unfortunately, this goal has not been realized when a priority competition arises between a bank that holds a Bank Act security device and a credit grantor who holds a security right regulated by provincial law. The priority rules of the Bank Act cannot easily be harmonized with the priority rules of the provincial secured transactions regimes. This has led to significant uncertainty in determining priorities, and was the primary impetus behind calls for reform of the law in this area.

II. The Priority Problems

Neither the Bank Act nor the provincial secured transactions statutes provide a complete set of priority rules that govern a competition between a Bank Act security and a security right regulated by provincial law. Four different priority problems have arisen as a result of this gap.

Problem 1

The first problem is that the rules for resolving a priority competition between a Bank Act security and a provincial security right are not clear. A priority competition between a Bank Act security and a provincial security right is generally determined according their order of creation. The Bank Act security only attaches to the debtor’s rights in the property. A prior provincial security right therefore has priority over a subsequent Bank

Act security. Although a Bank Act security will generally have priority over a subsequent provincial security right, courts have held that a Bank Act security does not have priority over a seller who has reserved a security right in the collateral. There is considerable uncertainty at present whether this priority extends against a lender who has made a loan for the purpose of allowing the debtor to acquire the new asset. As well, a serious problem has arisen in the common law jurisdictions. The difficulty is that provincial law does not subordinate an unregistered provincial security right as against a subsequent Bank Act security. This produces a commercially unacceptable outcome, as there is no means by which a bank can learn of the existence of the unregistered security right. This problem does not arise in Quebec, since unpublished security rights are not effective against third parties.

Problem 2

The second problem concerns production security rights. Provincial secured transactions legislation in the common law jurisdictions provides that a security rights in crops given to enable the debtor to produce or harvest the crops has priority over another security right given in the same collateral. In addition, most common law provinces and territories (other than Ontario) provide a similar priority in respect of animals where the credit enables the debtor to acquire food, drugs or hormones for animals. Although these production security rights are given priority over a prior provincial security rights in the crops or animals, the situation is different if the prior secured party is a bank which holds a Bank Act security. In this case, the production security right priority is not available. Instead, priority will be given to the bank on the basis of the usual first in time rule of priority. This substantially undercuts the value of the production security right priority and makes it more difficult for agricultural and aquacultural producers to finance the acquisition of production inputs.

Problem 3

The third problem concerns the practice of double documentation under which a bank is given both a Bank Act security and a provincial security right in the same collateral to secure the same obligation. The issue is whether the bank must make a choice between which security right it wishes to rely upon, or if it can assert its Bank act security against one party and its provincial security right against another party. Some cases suggest that the bank must make an election, while other cases suggest that the bank can pick and choose as it sees fit. Saskatchewan is the only province that has directly dealt with this issue. The Saskatchewan Personal Property Security Act provides that a security interest in collateral is void to the extent that it secures payment or performance of an obligation that is also secured by a Bank Act security. In Saskatchewan, the use of overlapping security agreements will therefore result in the non-application of the provincial secured transactions regime in relation to any collateral upon which a bank holds Bank Act security.

Problem 4

The fourth problem concerns the status of the bank's claim to the proceeds of a sale of collateral covered by a Bank Act security. Unlike the provincial secured transactions statutes of the common law provinces, the Bank Act does not provide that its security right extends to proceeds. Banks typically include in their security agreements a trust proceeds clause which requires the debtor to hold the proceeds in trust for the bank. There is uncertainty over the application of the provincial statutes to the bank's claim to the proceeds and as to the priority rules that would govern the outcome of a dispute between the bank's proceeds claim and a secured party who has a provincial right in the same collateral.

II. THE OPTIONS

The Study Committee has identified three possible paths along which reform of the law might proceed. Each option will be described, followed by a brief commentary that describes the advantages and disadvantages of each response.

Option A: Repeal the Bank Act Provisions

The first option would be to do away with the federal security system through the repeal of sections 427 to 429 of the Bank Act. Banks that wish to take security rights in the personal property and moveables of their debtors would do so by taking a provincial security right.

One advantage of this option is that it results in a more efficient and less complex legal environment. The co-existence of both a provincial and a federal secured transactions system imposes additional search and registration costs. A third party who wishes to acquire an interest in the personal property or moveables of another must undertake a search of both the provincial and the federal registries in order to determine if property is encumbered. Option A would result in a cost-saving for these parties. A buyer or lender would only need to conduct a search of the provincial registry system.

Another advantage is that it creates a fairer system. One criticism of the Bank Act system is that it creates a non-level playing field in favour of banks and to the disadvantage of non-bank credit granting institutions. Banks are able to take both Bank Act security and provincial security rights to secure their loans, while credit unions, small loan companies and other non-bank lenders are only able to take provincial security rights. This may allow banks to obtain an enhanced priority position over competing non-bank financial institutions. In addition, the Bank Act security device insulates banks from the application of provincial consumer and farm protection legislation whereas non-bank institutions are subject to these laws. Option A would result in similar treatment being afforded to banks and other credit granting institutions.

The disadvantage to Option A is that it results in the loss of a long-standing secured financing regime that is widely used by banks. The fact that the Bank Act security is a federal security device means that banks are able to use the same forms and the same procedures throughout Canada.

Option B: Harmonization of the Priority Rules of Section 427 with Provincial Priority Rules

The second option would be to retain the Bank Act security system and devise a set of priority rules that would eliminate the priority problems identified in this consultation document. Banks would continue to be able to take Bank Act security to secure their loans. The harmonization of the priority rules would mean that a more predictable set of priority rules and more commercially sensible outcomes would be attainable when a priority competition arose between a Bank Act security and a provincial security right.

Under Option B, the Bank Act security would continue to be registered in a federal registry, while provincial security right would be registered in the provincial registry. In order to implement Option B, it would be necessary to introduce provisions in the federal and provincial statutes that would provide a first to register rule of priority. A Bank Act security would no longer be defeated by an unperfected or unpublished security right in the common law provinces. Further legislative provisions would be added in order to address the production security interest priority, dual documentation and the proceeds issues.

The advantage of Option B is that it would solve the priority problems that have arisen under existing law without requiring financial institutions from substantially changing their current procedures and practices.

The disadvantage of Option B is that it would still be necessary for third parties to conduct multiple searches. A search of both the federal registry and the provincial registry would be required in order to determine if the debtor s property is subject to a security right. One variation to Option B would be to eliminate the federal registry system and require the Bank Act security to be registered in the provincial registry. This would eliminate the problem of dual searching, although it would not eliminate the complexity involved in having two vastly different bodies of secured transactions law.

Option C: Creation of a Federal Secured Transactions Regime

The third option would be to replace the present Bank Act system with a modernized federal secured transactions system. This new federal system would be based upon provincial secured transactions legislation. Option C would therefore involve the repeal of sections 427 to 429 of the Bank Act and the enactment of a modern federal secured transactions statute based upon the same language, concepts and structure as provincial legislation. The priority rules of this new federal statute would be harmonized with provincial law so as to provide similar priority rules (i.e., a first to register rule of priority).

The advantage of Option C is that it would provide a solution to the priority problems discussed in this consultation document, while also reducing much of the complexity that exists under the existing law. At present, it is necessary for users of the system to understand two fundamentally different personal property security systems. This complexity would be reduced since both the federal and the provincial systems would share the same terminology, concepts and approaches.

As with Option B, the disadvantage of Option C is that it still be necessary for third parties to conduct searches of both the provincial and federal registries in order to determine if the debtor s property is subject to a security interest. Indeed, this problem would become even greater under this option. At present, the Bank Act security is limited in its availability. Only certain categories of borrowers can grant the security, and only certain categories of goods can be given as collateral. A federal secured transactions statute Act would eliminate these restrictions and permit a debtor to grant a federal security right in all of the debtor’s present and after-acquired personal property or moveables. This expansion in scope would result in a significant increase in the use of the federal security device, which in turn would result in an increase in the number of occasions where a third party would need to conduct multiple searches.

Another difficulty concerns the interaction of a modernized federal secured transactions statute with the Civil Code system that governs personal property security law in Quebec. Although this civil law system shares some of the attributes of Article 9 of the United States and the Personal Property Security Acts of the common law provinces, the Civil Code takes a different conceptual approach on several important matters and it must be recognized that it operates as a distinct and different system of law. Although a federal statute Act might be designed so as to operate harmoniously with the Personal Property Security Acts of the common law provinces, it would be far more difficult to design the system so that it also operated harmoniously with the civil law system in Quebec.

III. The Tentative Conclusion of the Study Committee

The three options that have been described above document were carefully considered by the Study Committee. It is the unanimous view of the Committee members, that Option A is preferred.

The Committee was of the view that the creation of a separate secured transactions system available only to banks gives an unfair advantage to banks over other non-bank lenders. Moreover, it was of the opinion that the co-existence of both a federal and a provincial secured transaction regime leads to great inefficiencies, since interested parties must conduct multiple searches of registries before entering into transactions. The Committee acknowledged that the Bank Act security provisions at one time played a vital role in the Canadian economy due to defects in provincial law which made it difficult for banks to obtain effective security in the assets of their customers. However, the Committee was of the opinion that these defects have been remedied, and that a highly effective secured transactions system now exists in every province and every territory in Canada, and that there no longer is a useful role to be played by a federal secured transactions regime. Although the Bank Act security provisions might be reformed so as to reduce some of the uncertainties as to priorities, the Committee was of the view that these problems can only be reduced and not eliminated.

PLEASE OFFER YOUR VIEWS ON THE QUESTIONS RAISED IN THIS PAPER BY SUBMITTING YOUR RESPONSE TO THE QUESTIONNAIRE.

BACKGROUND PAPER 2

PRIORITY COMPETITIONS INVOLVING PROCEEDS OF INVENTORY: PMSI INVENTORY FINANCERS *VS*. ACCOUNTS FINANCERS

I. CONTEXT

The issues addressed by this paper arise in the following scenario:

> *A business debtor has financed the acquisition of inventory through either the extension of credit by the inventory supplier, or by procuring funds for the purchase of inventory from a third party lender. In either case, the financer acquires a purchase money security interest (hereafter, pmsi) in the inventory within the meaning of the definitions included in all Canadian PPSAs. The inventory financer perfects its security interest in inventory by registering a financing statement and otherwise complying with those requirements of the PPSAs conferring pmsi priority.*
>
> Accounts receivable generated by sale of the inventory are "proceeds" of the original collateral, in which the inventory financer acquires a security interest by operation of law.[1] That interest has the same status as the security interest in the original collateral, i.e., the inventory financer has a pmsi in the accounts receivable.[2] The proceeds security interest in the accounts is perfected as a result of the prior registration of the financing statement, which included accounts in the description of collateral.[3] In the result, the inventory financer has a perfected pmsi in the accounts receivable.

[1] The *PPSAs* of all jurisdictions provide that a security interest taken in original collateral extends to its proceeds. See *e.g.* Saskatchewan *PPSA* s. 28(1).

[2] See *e.g.* Saskatchewan *PPSA* s. 34(3), which confers priority on "a purchase money security interest in inventory *or its proceeds*".

[3] See *e.g.* Saskatchewan *PPSA* s. 28(2).

- *Variation 1:* The debtor has procured funds for other purposes from a lender who has taken a security interest in (or security assignment of) the debtor's accounts. The accounts financer has perfected its security interest by registering a financing statement *before* the financing statement was registered by the inventory financer.

- *Variation 2:* The debtor has sold and assigned its accounts receivable to a third party. The assignee has registered a financing statement relating to the assignment of accounts *before* the financing statement was registered by the inventory financer.[4]

The inventory financer and the accounts financer (in *Variation 1*) or assignee (in *Variation 2*) both claim priority with respect to the accounts.

II. CURRENT LAW

There are, among the *PPSAs* of the Canadian provinces and territories, three different approaches to resolution of these priority disputes. In each case, a single priority rule applies to both security interests taken by an accounts financer in the debtor's accounts (*Variation 1*) and absolute assignments of accounts (*Variation 2*).[5] The three options currently represented by the *PPSAs* may be summarized as follows:

Option A:

The inventory financer takes priority on the grounds that it holds a perfected *pmsi* in the accounts. Priority with respect to accounts generated as proceeds of inventory subject to a *pmsi* is determined on the same basis as priority with respect to other forms of proceeds of collateral of that kind. No special rule is required.

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[4] Registration of a financing statement is necessary to protect the interest of the assignee under the *PPSAs* of all jurisdictions except Ontario. However, assignees may elect to register in Ontario in order to avoid potential issues arising from the question of whether the transaction is or is not in substance a security agreement.

[5] See *e.g.* Saskatchewan *PPSA* s. 3(2), Ontario *PPSA* s. 2(1)(b), providing that the *Act* applies to a transfer of an account that does not secure payment or performance of an obligation – *i.e.*, that is not in substance a security agreement.

This is the result under the Ontario *PPSA*.

Option B:

The inventory financer takes priority on the basis of its perfected *pmsi* in the accounts *provided that* it has given advance notice of its intention to take a *pmsi* in inventory to the accounts financer.

This is the result under the *PPSAs* of the Atlantic provinces.[6]

Option C:

The accounts financer has priority *provided that* it has given new value for its security interest in the accounts in question.

This is the result under the *PPSAs* following the Model Act – *i.e.*, those of the Western provinces and the territories.[7]

This approach applies to accounts in any form that are proceeds of inventory, including deposit accounts in a financial institution, except in Saskatchewan, which excludes deposit accounts from the application of the rule.[8]

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[6] See *e.g*. New Brunswick *PPSA* s. 34(2)(b), which provides that the notice to be given by a purchase money financer of inventory to establish the *pmsi* priority must be given to;

> *"...any other secured party who has registered, before the registration of the financing statement relating to the purchase money security interest in the inventory, a financing statement where the collateral description in the financing statement includes the same item or kind of collateral or includes accounts."*

[7] The relevant provision of the Model Act (see also *e.g.* Saskatchewan *PPSA* s. 34(6)) is as follows:

> *34.(6) A non-proceeds security interest in accounts that is given for new value has priority over a purchase-money security interest in the accounts as proceeds of inventory if a financing statement relating to the security interest in the accounts is registered before the purchase money security interest is perfected or a financing statement relating to it is registered.*

[8] See Saskatchewan *PPSA* s. 34(7).

Civil Code

The Civil Code represents a distinct approach to the scenario as it might arise in Quebec. Under Quebec law, a security interest in inventory does not extend to or continue in the accounts receivable generated by sale of that inventory. The inventory financer may only acquire an interest in those accounts by taking a security interest in them as original collateral. A priority dispute over the accounts is accordingly determined on the basis of first to register. In the scenario given, the accounts financer would win. The result is therefore essentially the same as that produced by Option C above.

The Study Committee has identified two issues that arise in the context of this inter-provincial diversity of approaches. (1) Which of the approaches is to be preferred as the basis for a harmonized approach? and (2) Is harmonization desirable?. The Committee was not able to reach a consensus on Issue 1. However, given its tentative conclusion on Issue 2, it is of the view that consensus may not be necessary.

ISSUE 1: WHICH APPROACH IS PREFERRABLE?

Option A: (Ontario PPSA)

The positives of this approach include following:

- it maximizes the security position of purchase money inventory financers.

- it imposes no special notice or registration requirements on inventory financers who wish to claim accounts generated by the sale of inventory as collateral. That is, nothing is required supplementary to the general notice upon which *pmsi* priority in inventory is based.[9]

[9] See Ontario *PPSA* s. 33(1)(b) and to similar effect Saskatchewan *PPSA* s. 34(3)(b).

- it applies the same priority rule to all proceeds of inventory that is subject to a *pmsi*, regardless of their form (*i.e.*, whether accounts receivable, deposit accounts, chattel paper, trade-ins or otherwise).

The negatives of this approach include the following:

- it limits the ability of accounts financers to predict and manage their lending risk, particularly in connection with future accounts. Their priority position *vis-à-vis* any given account generated by sale of the debtor's inventory will depend upon whether that account is proceeds of inventory subject to a *pmsi* As a consequence, accounts financers may refuse to lend on the security of future accounts or may overcollateralize against accounts, thereby reducing the credit available to the debtor.

- a purchaser of accounts who takes an absolute assignment may lose its entitlement to those accounts to an inventory financer in spite of having paid for them and having properly registered a financing statement. The potential for this to occur may impede securitization of accounts (*i.e*., the sale of accounts in bulk by the original holder or an assignee).

- the assumption that inventory financers depend upon accounts receivable as a source of security may be disputed. The legislatures of the Western provinces and, to a somewhat lesser degree, the Atlantic provinces have acted on the view that inventory financers other than banks and credit unions are not ordinarily equipped or inclined to deal with accounts as collateral. To the extent that they rely on proceeds, inventory financers are regarded as more likely to look to trade-ins and chattel paper.[10] On this view, the protection of inventory financers' rights to accounts receivable arising as proceeds is unwarranted.

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[10] In Saskatchewan, they may also look to cash proceeds of inventory, including deposit accounts. See note 8.

- funds supplied by the accounts financer are not infrequently used to pay the inventory financer. In such circumstances, the accounts financer is unfairly disadvantaged by loss of the accounts to the inventory financer.

- it is inconsistent with the approach taken under Quebec law.

- it is inconsistent with the priority rule represented by revised section 9-324 of Article 9 of the Uniform Commercial Code, which adopts the approach embodied in option 3.

Option B: (Atlantic Provinces)

The positives of this approach include the following:

- it enables purchase money financers of inventory to protect their claim to accounts generated by sale of the inventory if they wish to do so, by giving notice to previous accounts financers and purchasers who have registered a financing statement.

- it assists accounts financers in their risk management assessment and practices by enabling them to better predict their priority position with respect to accounts receivable generated by sale of the debtor's inventory.

- it offers some protection to accounts purchasers who take absolute assignments of accounts.

- it attempts to balance the interests of account and inventory financers.

The negatives of this approach include the following:

- since accounts financers cannot establish an indefeasible priority position with respect to future accounts of a debtor, they may be unwilling to lend on the basis of security in accounts or may overcollateralize, thereby limiting the debtor's borrowing facility.

- the inability of accounts purchasers to establish indefeasible priority may impede securitization of accounts.

- the notice requirement associated with protection of the *pmsi* priority in accounts involves an additional administrative burden and creates transactional inefficiency.

- resolution of priority disputes is complicated by the need to establish by appropriate evidence whether or not notice was properly given by the inventory financer to previously registered accounts financers or purchasers.

- like Approach 1, this approach rests on the (debatable) assumption that accounts receivable are an important source of collateral for inventory financers, as compared with prior accounts financers.

- like Approach 1, this approach is not consistent with that taken by Quebec law.

- like Approach 1, this approach is inconsistent with the priority rule adopted by Article 9 of the Uniform Commercial Code.

Option C: (Western provinces, the territories and Quebec)

The positives of this approach include the following:

- it facilitates a business borrower's access to financing through accounts financers by assuring the latter of priority without restricting (significantly or arguably at all) the availability of purchase money financing. Inventory financers may rely on other forms of proceeds, as well as their original collateral.[11]

- it fully protects purchasers of accounts. It therefore facilitates the increasingly prevalent practice of securitization of accounts.

- it is comparable to that taken under Quebec law.

- it is consistent with revised Article 9 of the Uniform Commercial Code and thus with the law of the American states.

The negatives of this approach include the following:

- it limits the security available to purchase money financers of inventory.

- it rests in part on the potentially debatable view that inventory financers do not rely heavily on accounts generated by the sale of inventory as collateral, and that it therefore does not significantly limit the availability purchase money financing.

ISSUE 2: IS HARMONIZATION DESIRABLE?

It is widely accepted that uniformity in the law across Canadian jurisdictions is generally desirable, especially in the commercial realm. Ideally, a single rule would determine priority in all jurisdictions in competitions between accounts financers and purchase money inventory financers claiming accounts as proceeds. However, the Study Committee is aware of no compelling evidence suggesting that the current diversity of approaches is creating significant difficulty, either in terms of legal uncertainty or in terms of the availability of credit to business debtors. While uniformity on this point is no doubt desirable, it may not be essential.

[11] In Saskatchewan they may also assert priority with respect to cash proceeds, including proceeds in the form of deposit accounts. See note 8.

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BACKGROUND PAPER 3

FACILITATION OF CROSS-BORDER SECURED FINANCING: HARMONIZING CHOICE-OF-LAW RULES ON SECURITY IN MOVABLE PROPERTY

I. INTRODUCTION

Achieving inter-jurisdictional consensus on the "conflict of laws" (private international law) rules that determine which jurisdiction's law is to apply constitutes one effective means of reducing the legal risk presented by substantive differences in legal rules when a transaction or activity crosses borders. All the Canadian provinces and territories have enacted reasonably comprehensive conflict of laws rules for security in movable (personal) property. In the common law provinces and the territories, the rules are contained in the PPSAs. In Québec, they are set out in Book Ten on Private International Law of the CCQ. These rules are broadly harmonious with each other and with the thrust of modern opinion internationally. However, they are sometimes implemented in different ways, and certain aspects of the rules require clarification or reform to bring them into line with each other and with contemporary practice.

This background paper sets out those aspects of the current rules that the Study Committee considers in need of reform, either in the interests of harmonization or in the interests of clarification or modernization.

This background paper contains three additional parts. Part II contains tentative conclusions that reflect a consensus of the Study Committee on the precise shape of reform. Part III contains an examination of issues with respect to which it was agreed that harmonization would be desirable but agreement on the most appropriate rule could not be reached. Hence this part simply describes the competing advantages and disadvantages of the possible reform options. Part IV of the Report addresses the desirability and feasibility in a Canadian context of adopting a unitary choice of law rule for registration along the lines of revised Article 9 of the Uniform Commercial Code in the United States. Part V identifies a number of minor amendments and clarifications that the Study Committee believes to be both desirable and uncontroversial.

II. TENTATIVE RECOMMENDATIONS FOR HARMONIZED RULES

A. The Location of Multi-jurisdictional Granter Enterprises

Under both the PPSAs and the CCQ, the law of the location of the granter of security governs the validity, publicity, and effects of publicity or non-publicity for security granted in intangible property and “mobile goods" i.e., a tangible asset normally used in more than one jurisdiction, e.g. a transport truck or aircraft or rolling stock.

However, the place where the grantor is located is not defined in the same manner in the PPSAs and the CCQ. The most significant difference arises where the granter has places of business in more than one jurisdiction. Under the CCQ, reference is then made to the law of the jurisdiction in which the granter maintains its statutory seat (i.e. its registered head office) whereas the PPSAs refer to the law of the location of the granter's chief executive office.

This difference means that it is sometimes necessary to comply with the laws of more than one province in order to obtain and publicize a valid security interest that will be respected by the courts in all provinces where a subsequent dispute might be litigated. For example, if the granter maintains its registered office in Québec and its chief executive office in Ontario (or vice versa), a prudent secured creditor will need to register, and interested third parties will need to conduct searches, in the registries of both provinces. Moreover, since the priority effect of registration (or non-registration) may be different under the substantive laws of the two provinces, any priority dispute arising out of the transaction may be decided differently depending on whether it is adjudicated before the Ontario or the Québec courts.

The CCQ and PPSA approaches each have their advantages and disadvantages. A legal enterprise's registered office is far easier to verify through a simple check of the corporate or other business organization records than the location of its chief executive office, an inherently fact-specific and occasionally ambiguous exercise. Moreover, a company's registered head office is less easily relocated and less prone to relocation than its administrative centre.

However, a registered head office test for location raises concerns in the context of a business entity whose real centre of business is in one place but which is constituted under the law of some other place for tax or similar extraneous reasons. The law of the jurisdiction where the security granter conducts its real day-to-day business is more likely to be in the reasonable contemplation of other secured and unsecured creditors, and prospective buyers, who enter into business dealings with it. It is also the place where the principal insolvency proceedings involving that granter are most likely to be commenced. Accordingly, a chief executive office test would better ensure that the law governing the publicized status and third party effects of the security would coincide with the law governing the granter's insolvency. This in turn would eliminate the costs of having to plead and prove a foreign law in insolvency proceedings, and remove any potential for conflict between the priority rules of the applicable law and those of the insolvency forum.

These third party concerns are more acute in the international context. Nationally, there is less potential for third party prejudice owing to the federal character of Canadian bankruptcy and insolvency law and the broadly harmonious character of Canadian corporations and secured transactions legal policy.

The Study Committee has tentatively concluded that a registered office or equivalent test along the lines of the current CCQ approach should be adopted by all provinces and territories for legal entities constituted under federal law or under the law of a province or territory. On the other hand, for entities constituted under foreign law, the Study Committee considers that a chief executive office or an equivalent "centre of *administration" test would be more appropriate taking into account the interests of third parties particularly in the insolvency context.*

This dual approach would have the advantage of conforming to the test for location adopted in revised Article 9 of the Uniform Commercial Code in the United States. It is also consonant with international developments. The recently adopted United Nations Convention on the Assignment of Receivables in International Trade refers issues of priority (defined to include proprietary validity and publication or registration) to the law of the assignor's (i.e. granter's) location. In the case of an assignor (granter) with multiple locations in more than one state, location is defined by reference to its "centre of administration" (equivalent to chief executive office). However, in recognition of the certainty advantages of a registered office rule within federal states, the Convention accommodates the use within a Contracting State of a different approach to determine the location within that Contracting State of a business entity organized under the internal laws of that State.

B. Law governing the Characterization of Security Interests

The Study Committee has tentatively decided that a provision should be added to the PPSAs to confirm that the term "security interest" for the purposes of the PPSA choice of law rules means any interest that, under the law of the enacting jurisdiction, would constitute a security interest.

This would ensure that the PPSA choice of law rules are applied even when the governing law would not characterize the interest in question as a security interest.

C. Scope of Transactions Subject to Choice of Law Rules for Security

Under the PPSAs, a transaction where the secured creditor holds title to the collateral as security for an obligation is considered to be a security interest and the PPSA conflicts rules therefore govern such a transaction (e.g. a conditional seller's retention of title or a financial lessor's retention of title). It follows that the applicable conflict rules will be the same as if the granter had been the absolute owner of the goods and had granted a charge on them in favour of a lender.

In contrast, under the CCQ, transactions where the granter does not own the asset securing the obligation are not considered to be security rights (hypothecs) in the strict sense. A hypothec is defined as a real right granted in property owned by the grantor of the right. Secured transactions whereby the granter does not have title to the charged assets are thus not considered to be hypothecary in character. The most common examples of such title-based "quasi security interests" are a sale with a title reservation agreement (i.e. a conditional sale), a leasing agreement (i.e. a financial lease) and a trust for security purposes.

It is not clear what are the conflicts rules currently applicable to these quasi-security interests: the choice of law rules governing hypothecs or the general choice of law rules for transfers of movable property? The CCQ is silent on the issue and either approach is possible. For tangible assets generally, it does not matter practically which approach is taken; the applicable law will be the same since the same *lex situs* rule for movables applies to both security and quasi-security title transactions. However, for mobile goods or intangible property, the Code on its face seems to require application of the law of the location of the grantor in the case of a non-possessory hypothec, and application of the actual or notional lex situs of the charged assets in the case of a title-based quasi-security.

The Study Committee has tentatively decided the CCQ should be amended to explicitly confirm that quasi security interests are assimilated to hypothecs for private international purposes.

This functional approach would ensure that the same choice of law rule applies where a Québec court is required to rule on the competing claims of a hypothecary creditor and the holder of a quasi-security interest. This would also result in a closer harmonization of Québec conflicts policy with the conflicts policy of other North American jurisdictions.

The PPSAs apply to certain transactions that raise publicity concerns for third parties even though they do not secure payment or performance of an obligation. These "deemed security interests" includes sales of accounts and, except in Ontario, non-financial leases of more than one year in duration and commercial consignments.

In Québec, under the CCQ, sales of accounts and true leases of more than one year in duration are treated as analogous to hypothecs for the purposes of publicity but not for private international law purposes. Consequently, a true sale of accounts and a non-financial lease would not be governed by the conflict rules applicable to hypothecs. The applicable conflicts rule is instead the general rule applicable to real rights in property: the (notional) lex situs.

This solution is cumbersome where a business sells a group of accounts receivable owed by customers located in several provinces or countries. Assuming that the notional situs of an account receivable is the place of business of the account debtor, the buyer would not acquire an effective title against third parties in the eyes of Québec law unless it complies with the internal laws of all the jurisdictions where the various account debtors are located.

In the common law provinces, since a sale of accounts (like the other deemed security interests) falls within the scope of the PPSA conflicts rules, it suffices to comply with the law of the seller's location. This ensures that the same law, regardless of whether the assignment is by way of sale or for security purposes, governs the perfection (publicity) and priority of the buyer's interest. In contrast, under the current CCQ bifurcated rule, there is a risk that the same item of collateral will be subject to different and potentially conflicting laws in a case where the accounts are the subject of both a secured transaction and a sale by the same person. To avoid this result, the United Nations Convention on the Assignment of Receivables in International Trade adopts the same conflict of laws solution as the PPSAs.

The Study Committee tentatively recommends thatan approach contained in the PPSAs be considered for adoption in the CCQ for both outright assignments of claims and true leases of more than one year.

D. Effect of an Unauthorized Transfer of Collateral to a Third Party Located in Another Jurisdiction

The following scenario illustrates the context in which the harmonization issue under this heading arises:

> D (debtor), located in Province X, grants a security interest in certain intangible assets to SC1 (secured creditor) who files its security interest in Province's X registry. In breach of the security agreement between D and SC1, D transfers an interest in the assets to B, located in Province Y. B then grants a security interest in the same assets to SC2 who registers in Province Y's registry because this is where B is located.

SC1's security interest would prevail against SC2 under the Ontario and Québec regimes. The rule is different under the PPSAs in common law provinces other than Ontario In order to preserve its original publicized status obtained by registration under D's home law (here Province X), SC1 has to re-register its security in accordance with the law of the jurisdiction where B is located (here Province Y) naming B as a new granter of the security.

Each approach has its merits. A requirement for timely re-registration protects third persons who deal with a cross-border transferee from the granter of the security and who would reasonably presume that a search of the registry in the jurisdiction where the transferee is located would disclose any security interests granted in the collateral. On the other hand, the rule imposes a heavy burden on secured creditors. To protect themselves, they must monitor the grantor's activities, ascertain the location of the transferee if an authorized cross-border transfer is made, and then make a timely re-registration at the transferee's location.

The Study Committee believes that a compromise between the two policies would most fairly balance the interests of the secured creditor on the one side and the interests of third parties on the other.

The Study Committee has tentatively concluded that a secured creditor should be required to re-register within a stipulated "grace period" in the event of a cross-border transfer, we further recommend that the running of this grace period not be triggered until the secured creditor acquires actual knowledge of the transfer.

This approach would have the added advantage of bringing the PPSA requirements for re-registration against the name of the transferee in the case of a cross-border transfer into line with the PPSA re-registration requirements that apply in the case of an unauthorized domestic transfer.

III. ADDITIONAL ISSUES FOR HARMONIZATION

A. Choice of law for Enforcement

The PPSAs currently provide that procedural issues relating to the enforcement of a security interest are governed by the law of the jurisdiction in which the collateral is located in the case of tangibles, and by the law of the forum in the case of intangibles. The CCQ does not deal explicitly with the issue but the solution seems to be the same for tangible property; the position is unclear with respect to intangible property.

In line with general conflict norms, the Study Committee has concluded that all regimes be amended to provide that the law of the forum where enforcement is pursued governs enforcement procedure. This approach is based on the understanding that procedure is to be read in the modern, narrow sense as encompassing only issues that relate to the manner of enforcement as opposed to the substantive pre-conditions for enforcement or the substantive default remedies and obligations of the granter and secured creditor.

As to the law applicable to such substantive enforcement issues, the Study Committee was unable to reach a consensus on the most appropriate approach. The PPSAs currently provide that the proper law of the contract between the secured party and the granter governs substantive issues relating to the enforcement of the rights of a secured party against collateral. In other words, the parties are free to agree on the remedies that the secured party may exercise (although we assume this would be interpreted as applicable only in the absence of a mandatory legislative provision to the contrary of the most closely connected law for that issue). The CCQ does not have a similar rule and two approaches are possible: the law governing the validity of the security (because remedies against the collateral are closely linked with the nature of the interest of the secured party) or the *lex situs* (for policy reasons and because this is the residual rule for proprietary interests in general).

B. Security in Intangible and Mobile Goods: Effect of Absence of a Public Registry System under Otherwise Applicable Law

For jurisdictions that require public registration as a pre-condition to the third party effectiveness of a security interest, the prospect of having to refer perfection (publicity) and priority to a governing law that does not have an equivalent public disclosure system may well create concern. The conflicts regimes in the non-Ontario PPSAs seek to protect local interests in this situation by creating an explicit exception to the general application of the law of the granter's location to issues of perfection and priority for security in intangible and mobile goods.

Under the relevant provision, the security must be perfected in accordance with the law of the enacting jurisdiction if the law of the jurisdiction where the granter is located does not provide a public registration system for giving notice of the security. This exception is designed to protect local creditors and other third parties who acquire an interest in assets subject to a security that is not searchable in any jurisdiction, but which they would perceive as having at least a notional location in the province where they are located. In the case of mobile goods and documentary intangibles, failure to perfect locally subordinates the security to an interest acquired in the collateral while it was situated in the enacting jurisdiction. In the case of intangible collateral, the security is subordinated to an interest acquired in an account payable in the province.

A similar if somewhat less refined policy informs revised Article 9 of the Uniform Commercial Code in the United States. A foreign granter whose home law does not require public registration is deemed to be located in the District of Columbia so as to require filing of a notice of the security in the DC registry as a condition of asserting rights in the collateral against competing claimants.

The Ontario PPSA and the CCQ do not provide any equivalent protection. The law of the granter's location governs perfection (publicity) and priority without regard to the presence or absence of a public registry under that law. Several justifications may be offered for this policy. First, all provinces and territories in Canada and all states in the United States now provide a public registry for giving notice of security in movables. This greatly reduces the practical need for any such exception. Second, local registration does not relieve a prospective secured creditor from the need to also assess the legal risk under the law of the granter's location. This is because, as a practical matter, priority disputes are most likely to be litigated in the state where the granter is located, and the courts in that state will apply their own substantive law to resolve that dispute. Third, at the international conflicts level, exceptions of this kind may be regarded as an attempt to super-impose domestic standards on security rights emanating from foreign granters and otherwise considered to be most appropriately governed by the law of the granter's location. It is for this latter reason that the United Nations Convention on the Assignment of Receivables in International Trade generally prohibits the displacement of the priority rules of the granter's state by reference to the super-mandatory priority rules of forum law.

After a lengthy discussion of the pros and cons of each approach, the Study Committee was unable to reach a consensus on whether a harmonized policy was achievable.

C. Effect of a Change in the Location of Tangible Assets on the Rights of a Subsequent Buyer or Lessee

Under all the regimes, the law of the location of any tangible assets charged with security governs the validity of the security, and the effects of publicity or non-publicity. If the assets are later relocated, the publicized status of the security is preserved so long as publication is effected in accordance in accordance with the new *lex situs* within a specified "grace period." However, the various regimes vary on the question of whether, and to what extent, the law should protect a buyer or lessee who acquires its interest after the assets are relocated but before the secured creditor re-publicizes its interest.

The non-Ontario PPSAs protect intervening buyers and lessees who acquire their interest before the date that re-publicity is effected locally provided they do not have any actual knowledge of the security. This approach rests on the justification that buyers and lessees should be able to rely on a search of the local registry to determine whether tangible assets located in their jurisdiction are encumbered by security.

The CCQ provides maximum protection for the secured creditor. So long as the secured creditor complies within the applicable grace period, the publicized status of the security right is opposable even against intervening buyers and lessees. At a policy level, this approach can be justified on the basis that a secured creditor may not find out about the relocation until after the granter has already sold or leased the collateral. Since the secured creditor's is required to republicize within a relatively short time period regardless of knowledge, it can be argued that this approach offers a fair compromise between protection of innocent secured creditors and protection of innocent buyers and lessees.

The Ontario approach is somewhere in the middle between the CCQ approach and the other PPSAs. Whereas the other PPSAs protect intervening buyers and lessees without limitation, the scope of the protection under the Ontario Act is limited to buyer and lessees of consumer goods.

The Study Committee was unable to reach any internal consensus on whether the issue at stake here should be left to local policy or was susceptible to a nationally uniform rule, and, if so, what that rule should be.

IV. CHOICE OF LAW FOR PERFECTION: POSSIBLE HARMONIZATION WITH REVISED ARTICLE 9 OF THE UCC

The former UCC article 9 conflicts regime shared a basic commonality with the PPSAs and the CCQ on the important issue of choice of law for perfection. This is no longer the case. For non-possessory security rights in intangibles and mobile goods, revised article 9 now bifurcates the law governing perfection and the law governing the effect of perfection or non-perfection and priority. The law of the location of the granter now governs perfection for all forms of collateral, whether tangible or intangible, subject to only very limited exceptions.

The introduction of a unitary perfection rule based on granter location is intended to reduce transaction costs for secured creditors involved in interstate transactions covering tangible collateral, notably inventory and equipment, located in multiple jurisdictions. Under the new rule, a single filing suffices to perfect a security interest in the granter’s assets wherever located, and whether tangible or intangible. The new rule also relieves secured creditors from the burden of having to monitor the location of the collateral and to re-file at the new situs in the event that the collateral is relocated. Although the secured creditor must re-file at the new venue in the event the granter changes its location, the location of the granter, especially a corporate granter, is less likely to change after the initial filing than the location of the collateral.

The Study Committee considered whether a similar rule would be desirable in principle or workable in practice in a Canadian context. It was pointed out that the de facto effectiveness of the Article 9 rule is questionable in international transactions. Application of the *lex situs* is likely to be the international norm since there seems to be a continuing consensus (UCC Article 9 aside) that the location of the granter is an inappropriate connecting factor for perfection in tangible collateral. Buyers, creditors, and insolvency administrators dealing with local tangibles simply do not anticipate having to investigate and comply with the perfection requirements of a remote legal system, which may not share the same legal tradition or language. Nor would they be likely to consider compliance with such a burden to be feasible.

In a Canadian context, the concerns that militate against a unitary perfection venue in international transactions also exist at the interprovincial level. In Canada, consumer protection against the risk of outstanding security interests in large ticket consumer goods is tied in with the provincial registration regimes. The problems that adoption of the new article 9 rule would create for consumer buyers are even more acute in Canada in the absence of provincial title certificate statutes for motor vehicles of the kind in effect under U.S. state law (which are in fact excepted from article 9's new unitary choice of law rule for perfection).

The concerns with preserving local regulatory authority over the publicity requirements for security interests are also more acute in a Canadian context. Article 9 is essentially uniform throughout the U.S. and will be even more so after the enactment of the new version. In contrast, in Canada, significant differences still exist among the provinces on what transactions should be subject to perfection by filing, most obviously between Québec and the common law provinces, but even among PPSA jurisdictions. If choice of law for perfection were to be referred to the law of the granter's location, this might undermine the policy choices of the province where the goods are located on what transactions require publicity. For instance, a true consignment or a true lease required to be registered under the law of the jurisdiction where the goods are located would nonetheless escape the perfection requirement if the granter happened to be located in a province that did not require publicity for these transactions.

Moreover, under revised article 9, the *lex situs* of tangible collateral at date a priority issue arises governs the effect of perfection or non-perfection and priority in tangible collateral. Conceptually, it is difficult to separate the issue of perfection from its priority effects. The whole purpose of a registration requirement is to give third parties access to information about the existence of an encumbrance against assets so as to regulate their priority rights against registered interests.

For the foregoing reasons, the Study Committee does not recommend adoption of the US approach. However, the Study Committee notes that the inconvenience created by different choice of law rules for perfection for different categories of collateral would be less acute if the provincial registries were linked in a way that would permit registration and searching across Canada through a single gateway. (Indeed, this feature is already available for the registries in the four Atlantic Provinces and the North West and Nuavut Territories).

The Study Committee decided to ask the ULCC to refer the question of harmonization of the registry systems and the creation of a common gateway to permit national access to the Canadian Conference on Personal Property Security Law for further consideration. The Study Committee underscores the importance of including Québec in these harmonization discussions.

V. NON-CONTROVERSIAL HOUSEKEEPING AND CLARIFICATION REFORMS

In this section a series of relatively minor and non-controversial.reforms are noted. In some instances the effect of the suggested amendment would be to eliminate any residual doubts on the meaning or sphere of operation of the relevant conflicts rule. In other cases, the object would be to bring the PPSAs into line with each other and/or in line with the CCQ on issues about which we believe there is little disagreement on the appropriate policy. The purpose of including these within the consultation paper is to test whether that assumption is correct.

A. Choice of Law for Priority

The various provincial and territorial regimes address the choice of law to govern the priority of a security right only indirectly. All provide a choice of law rule to determine the law applicable to the effects of publicity, or non-publicity, on third parties. This covers most potential third party priority disputes. But, technically, the rule may not cover more sophisticated issues of priority. A good example would be a priority contest between the holder of a registered or otherwise perfected security right and a buyer or secured creditor of the charged assets. As a general rule, the buyer or secured creditor would take subject to a prior perfected right under all regimes. However, for reasons of commercial practice or consumer protection, there are exceptions to this general rule. Since these exceptions are not uniform, among the PPSAs or between the PPSAs and the Civil Code, it is important that uniformity exist at the level of determining which provincial or territorial regime controls.

The Study Committee has tentatively concluded that all the provincial and territorial choice of law rules for publicity and the effects of publicity or non-publicity be expanded to explicitly bring priority issues within the scope of the reference of the rule.

B. Relocation of goods subject to a seller's right of revendication

Article 1741 of the CCQ entitles a seller of movable property to resolve the sale and revendicate the property within thirty days of delivery if the buyer is in default and fails to pay the price. Similar protection is afforded to unpaid sellers by article 2-702(2) of the Uniform Commercial Code.

Under section 5(5) of the Ontario PPSA, an extra-provincial seller's rights of revendication expire twenty days after the entry of goods into Ontario, unless the seller registers or repossesses the goods before the expiry of that twenty day period.

No equivalent provision appears in the other PPSAs or in the CCQ (in relation to UCC revendication rights). Special provision was thought to be unnecessary. First, the targeted revendication rights persist for a very short period: 30 days under the CCQ and 10 days under the UCC. Second, the seller is prevented from exercising its revendication rights under the CCQ if the goods have already passed into the hands of a third party buyer who has paid the price or a secured creditor who has obtained surrender (possession). So the only categories of third parties at risk for the additional 10 days when the right of revendication would persist if the Ontario rule were to be eliminated would be seizing creditors, a trustee in bankruptcy, and new secured creditors.

The Study Committee has tentatively concluded that section 5(5) of the Ontario Act should be repealed.

C. Elimination of renvoi

The granter location choice of law rule in the non-Ontario PPSAs currently brings into play not just the internal law but also the conflicts of laws rules of the jurisdiction in which the granter is located (renvoi)..

The Study Committee has tentatively concluded that this feature of the non-Ontario Acts should be eliminated.

D. Choice of law rules for possessory and non possessory security in reified intangibles

The PPSAs currently direct the application of different, potentially conflicting, laws to determine the validity, perfection, and effects of perfection or non-perfection of a security interest granted in a security, an instrument, a negotiable document of title, money or chattel paper. The law of the location of the collateral governs if the security interest is perfected by possession. The law of the location of the granter governs if the security interest is non-possessory. Where a non-possessory interest comes into conflict with a possessory interest, there is no explicit guidance on which legal regime applies to resolve the dispute- the lex situs of the collateral, or the law of the granter's location.

The Study Committee has tentatively concluded that paramountcy should to be given in this scenario to the law of the jurisdiction where the collateral is situated when the possessory interest is created.

This is justified on the theory that legal regimes generally award priority to possessory interests in negotiable collateral in the interests of protecting commercial negotiability.

The CCQ likewise excepts incorporeal movables established by a title in bearer form (a category that would essentially include the same categories as the PPSAs with the exception of chattel paper) from the scope of the granter location rule, meaning that the lex situs rule would apply by default. A similar clarification is, therefore, recommended for the CCQ.

E. Terminological Clarifications (PPSAs)

Under the PPSAs, the law governing the validity of a security interest is determined by reference to the location of the collateral or the granter, as the case may be, when the security interest attaches. The concept of attachment is not defined in the PPSAs. This could be a source of difficulties.

The Study Committee has tentatively concluded that it be made clear in the Acts that the term "attaches" does not refer to the domestic attachment rules of the PPSA, but to the rules governing the creation of a security under the applicable law.

The Study Committee has tentatively concluded that PPSAs be amended to confirm expressly that the law governing the validity, perfection, and priority status of a security interest in proceeds of original collateral is the law that that govern a security interest in proceeds of that kind if they were original collateral.

PLEASE OFFER YOUR VIEWS ON THE QUESTIONS RAISED IN THIS PAPER BY SUBMITTING YOUR RESPONSE TO THE QUESTIONNAIRE.

BACKGROUND PAPER 4

ANTI-ASSIGNMENT CLAUSES AFFECTING RECEIVABLES AND CHATTEL PAPER

I. BACKGROUND

Apart from Ontario, each of the PPSAs in Canada and Article 9 of the Uniform Commercial Code in the United States ensures the validity of a security interest in, or transfer of, accounts receivable and chattel paper despite any contractual term prohibiting or restricting that security interest or transfer.

The effect of a contractual anti-assignment clause is unclear at common law and under the Civil Code. At common law, the jurisprudence is clear that an anti-assignment clause can preclude the assignee from acquiring a right of action against the account debtor. As to the common law validity of an assignment as between the assignor and the assignee, the authorities do not clearly establish that every assignment would be valid. There is strong support for the view that, as a matter of public policy, an anti-assignment clause cannot operate to invalidate an assignment of the "fruits of a contract" in the hands of the assignor, as between the assignor and the assignee.[12] However, in the views of some, there remains a basis to conclude that a sufficiently broadly worded anti-assignment clause may render that type of assignment invalid even as between the assignor and the assignee. Moreover, where the assignee has knowledge of the anti-assignment clause, the tort of inducing breach of contract could provide the basis for additional uncertainty as to the validity of the assignment as between the assignor and the assignee.

The validity and effects of anti-assignment clauses are not addressed explicitly in the Civil Code. However, some analysts believe that an assignment in breach of an anti-assignment clause would be valid, not only as between the assignor and assignee and as

[12] *Yablonski v. Cawood* (1997), 143 D.L.R. (4th) 65, [1997] 3 W.W.R. 351, (*sub nom. Cawood v. Yablonski*) 152 Sask. R. 54, (*sub nom. Cawood v. Yablonski*) 140 W.A.C. 54, 3 W.W.R. 351 (Sask. C.A.).

against third parties but also against the debtor, by virtue of the general codal articles which limit the effectiveness of stipulations which attempt to restrict the free alienation of property rights by contract.

II. ARGUMENTS FAVOURING ANTI-ASSIGNMENT CLAUSES

The arguments in favour of enforcing an anti-assignment clause centre largely around the theory that contracting parties (*i.e.* the creditor assigning its account receivable and the account debtor which owes that receivable to the creditor) should be free to strike whatever bargain they please and their agreement should be respected. An additional concern is that once the owner of a debt has assigned it and the account debtor has received notice of the assignment, the account debtor can no longer set off any unrelated amounts owed to the account debtor by the assignor against the debt now owed to the assignee. This right of set-off can be particularly important if there is a continuing business relationship between the account debtor and the assignor out of which a claim by the account debtor against the assignor may arise.

III. ARGUMENTS AGAINST ANTI-ASSIGNMENT CLAUSES

Despite the arguments in favour of enforcing anti-assignment clauses, in the context of determining the rights as between the assignor and the assignee, the policy arguments against enforcement appear to be more persuasive. The right of an account debtor to restrict a transfer in order to protect its right of set-off must be weighed against the consequences of enforcing such clauses. A clause prohibiting the assignment of payment rights could severely restrict sources of financing that would otherwise be available to assignors if the law did not give effect to such clauses.

It has been argued in Ontario that denying efficacy to anti-assignment clauses would be harmful to consumer debtors. The objection is partly based on the mistaken belief that current law allows account debtors to sue an assignee for breach of contractual obligations of the assignor, and that the proposed change to the Ontario PPSA would limit that right. Account debtors generally cannot sue assignees for such breaches. This proposal does not change that current law, and in most (if not all) cases does not limit the rights of consumer debtors.

IV. THE STUDY COMMITTEE'S TENTATIVE CONCLUSION

On balance, the Study Committee prefers a policy favouring the assignability of accounts and chattel paper and the granting of security interests therein. This policy choice has been made in each PPSA jurisdiction[13] (apart from Ontario), in Article 9[14] and in the recently adopted United Nations Convention on the Assignment of Accounts Receivable in International Trade.

The Study Committee has tentatively concluded that the Ontario PPSA should be amended to bring it into conformity with the other PPSAs; and that Civil Code should be amended to produce the same result.

V. RATIONALE

In practice, the proposal is not likely to have any significant impact on consumers. The typical agreement for the purchase and sale of consumer goods and services does not expressly or implicitly prohibit the creditor from assigning the account receivable. The existing law permits a creditor to assign all or any portion of an account receivable in the absence of any express or implicit prohibition. The proposal does not change that law.

Moreover, the proposed rule would not affect the defences and claims available to an account debtor currently recognized in all PPSAs.[15] Those defences include the account debtor's right to assert equitable set-off in respect of sufficiently related claims whenever those claims arise – *i.e.* whether arising before or after the account debtor receives notice

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13 For example, see section 41(9) of the Saskatchewan PPSA. As noted in the text, the Ontario PPSA has no corresponding provision.

14 § 9-406(d) provides a rule of free assignability for accounts and promissory notes by explicitly overriding contractual restrictions and prohibitions; § 9-406(f) overrides any legal, as opposed to contractual, restrictions on assignment.

15 For example, see section 40(1) of the Ontario PPSA and section 41(2) of the Saskatchewan PPSA.

of the assignment. The account debtor would also be able to assert any legal rights of set-off existing at the time it receives notice of the assignment.

However, the account debtor would lose the right to assert legal set-off in respect of debts which arose after, or were not "liquidated" (*i.e.* fixed or ascertainable) when, the account debtor received notice of the assignment. Account debtors would still be able to protect themselves in respect of those debts by including contractual set-off clauses in their agreements with the assignor.

The recommended provision does not address the enforceability of prohibitions on *partial* assignments. While partial assignments have become an important practical issue in securitization transactions, the Study Committee was concerned that allowing partial assignments could impose undue hardship on account debtors.

PLEASE OFFER YOUR VIEWS ON THE QUESTIONS RAISED IN THIS PAPER BY SUBMITTING YOUR RESPONSE TO THE QUESTIONNAIRE.

BACKGROUND PAPER 5

LICENCES

I. THE ISSUES

The PPSAs in Canada are not consistent in their treatment of licences; and the law in this area is uncertain. This paper explores three questions:

? Should licences constitute "personal property" for the purposes of the law of secured transactions?

? If licences do constitute personal property, should the law ensure the validity of a security interest in a licence despite provisions in the licence or in other laws prohibiting the transfer of, or the creation of a security interest in, the licence?

? Third, if the licence constitutes personal property and the law recognizes that the security interest is valid, to what extent should the secured party be permitted to enforce its security interest and, conversely, to what extent should the rights of the licensor be protected?

The answer to each of the first two questions may depend on how the third question is answered. In light of these questions, the concluding portion this paper then asks for your input as to the appropriate responses.

II. TYPES OF LICENCES

The answer to the questions set out above could differ depending whether the licence is:

a. a transferable licence (*i.e.* a licence which is transferable with or without restriction or the consent of the licensor[16]) versus a non-transferable licence (*i.e.* a licence which cannot be transferred even with the consent of the licensor); or

[16] For example, see the definition of "licence" in section 2(1)(z) of the Saskatchewan PPSA.

b. a governmental licence (*i.e.* a licence issued by a government or regulatory body) versus a contractual licence (*i.e.* a licence issued by a non-governmental entity).

Some governmental licences are transferable – *e.g.* spectrum licences under the *Radiocommunication Act* (Canada) – while other governmental licences are non-transferable – *e.g.* milk quotas under the *Milk Act* (Ontario).

In contrast, all contractual licences are transferable (unless regulated by a statute prohibiting the transfer or creation of a security interest in the licence) because the licensor can always choose to consent to the transfer of the licence despite any contrary terms in the licence.[17]

Software licences are an important example of a contractual licence.

III. LICENCES AS "PERSONAL PROPERTY"

In some provinces (such as Ontario), the PPSA does not provide a clear test as to whether licences are included within the meaning of "personal property" used in the Act; and in those provinces it is often difficult to apply the judicially created test to determine whether a licence is or is not personal property.[18] In other provinces (such as Saskatchewan), the PPSA clearly addresses that question and indicates that transferable

[17] The Saskatchewan PPSA does not state clearly that all contractual licences are transferable; but this interpretation is implicit in the definition of "licence" in section 2(1)(z) of that Act. Accepting this view, it follows that all non-transferable licences would be governmental licences (except for those contractual licences, if any, regulated by a statute prohibiting the transfer or creation of a security interest in the licence).

[18] Among other decisions, see *Re National Trust Co. and Bouckhuyt* (1987), 61 O.R. (2d) 640 (C.A.); *Canadian Imperial Bank of Commerce v. Hallahan* (1990), 69 D.L.R. (4th) 449 (Ont. C.A.), leave to appeal refused (1991), 74 D.L.R. (4th) vii (S.C.C.); *Bank of Montreal v. Bale* (1991), 5 O.R. (3d) 155 (C.A.); *Sugarman v. Duca Community Credit Union Ltd.* (1999), 47 B.L.R. (2d) 34, 120 O.A.C. 333, 14 P.P.S.A.C. (2d) 264, 44 O.R. (3d) 257 (Ont. C.A.); leave to appeal refused (2000), 256 N.R. 399 (note), 135 O.A.C. 400 (note). In *Sugarman,* the Ontario Court of Appeal held, in effect, that a nursing home licence constitutes personal property because (a) the regulatory regime and practice provides, in substance, for the transfer of nursing home licences, (b) the discretion of the licensing body to refuse to renew or to revoke licences is not unfettered but confined to certain specific grounds, and (c) there is an appeal procedure under the regulatory scheme if a decision was made to not renew the licence.

licences are "personal property" for the purpose of the Act,[19] but non-transferable licences are excluded.

The Study Committee has tentatively concluded that all licences should be regarded as personal property, whether they are transferable or non-transferable; and whether they are governmental or contractual.

IV. VALIDITY OF SECURITY INTEREST IN LICENCES

If a licence does constitute personal property, should the law ensure the validity of a security interest in the licence despite provisions in the licence or in other laws prohibiting the transfer of, or the creation of a security interest in, the licence? None of the PPSAs clearly address this question.

The Saskatchewan PPSA empowers a secured party to "seize" a transferable licence by giving notice to the debtor (*i.e.* the licensee) and the licensor;[20] but the Act stipulates that the licensee's rights may be disposed of only in accordance with the terms and conditions under which the licence was granted or which otherwise pertain to it.[21] These provisions appear to recognize the validity of security interest in a transferable licence without expressly saying so. However, these provisions leave other questions unanswered. What is meant by "seize"? What are the consequences of "seizure"? Does the Saskatchewan PPSA permit a licensor to terminate a transferable licence where a security interest in the licence has been created in violation of the licence terms or applicable law?

Article 9 of the Uniform Commercial Code in the United States takes a different approach by clearly upholding the validity of a security interest in any licence, whether it is a transferable or non-transferable licence and whether it is a governmental or contractual licence.[22] Moreover, Article 9 prevents a licensor from terminating the

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19 See the definition of "licence" in section 2(1)(z) of the Saskatchewan PPSA.

20 Section 57(3).

21 Section 59(18).

22 See §§ 9-408(a) and 9-408(c); however, § 9-408(c) – dealing with governmental licences – does not override federal law to the contrary – see Official Comment, para. 9.

licence where a security interest in the licence has been created in violation of the licence terms or applicable law.[23] At the same time, Article 9 protects licensors by ensuring that they are not adversely affected by the creation of the security interest.[24]

It is worth noting that one of the principal reasons to recognize the validity of a security interest in a licence (whether it is transferable or non-transferable) is to ensure that a secured creditor is able to obtain a security interest in the proceeds of any disposition of the licence by a trustee in bankruptcy.[25] If there is no valid security interest in the licence, it is doubtful that a secured creditor can obtain a valid security interest in the proceeds of disposition where a trustee in bankruptcy (rather than the debtor) disposes of that licence.[26] This doubt would be eliminated if the PPSAs were amended to uphold the validity of a security interest in a licence where that security interest was granted in violation of the licence terms or applicable law. Where a non-transferable licence constitutes the most valuable asset of a business, the removal of this doubt may make it easier for that business to obtain secured financing.

V. POLICY CONSIDERATIONS

One basis for not recognizing the validity of a security interest in a non-transferable licence is that the law ought not to encourage financing based on the security of that type

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[23] §§ 9-408(a) and 9-408(c) provide that a term in a licence or in a rule of law that prohibits, restricts, or requires the consent of the licensor or of a governmental body to the transfer of, or the creation of a security interest in, the licence is ineffective to the extent that the term or rule of law would impair the creation of a security interest or may give rise to a default or right of termination under the licence

[24] See § 9-408(d), described below under "Enforcement Rights & Protection of Licensor".

[25] Technically, the trustee in bankruptcy might not be disposing of the licence; but instead selling all of the undertaking, property and assets of the bankrupt with the purchaser and the trustee working together to obtain the necessary governmental approvals for the issuance of a new licence to the purchaser.

[26] As to Anglo-Canadian law on this issue, see *Irving A. Burton Ltd. v. CIBC* (1982), 36 O.R. (2d) 703 (C.A.); *Re Anderson & Hiltz Limited; Re Dick; Scott & Pichelli Limited v. Dick* (1985), 57 C.B.R. (N.S.) 222 (Ont. S.C. in Bankruptcy); *Kent Steel Products Ltd. v. Arlington Management Consultants Ltd.* (1967), 62 D.L.R. (2d) 502 (Man. C.A.); *obiter dicta* in *Holy Rosary Parish (Thorold) Credit Union Limited v. Premier Trust Company; Re Robitaille*, [1965] S.C.R. 503; *In re Jones; Ex parte Nichols* (1883), 22 Ch. D. 782 (C.A.); *Wilmot v. Alton*, [1897] 1 Q.B.D. 17 (C.A.); *In re Collins*, [1925] Ch. D. 556 (Ch. D); R.M. Goode, *Principles of Corporate Insolvency Law*, (London, 1990) at pp. 18-19; *Chitty on Contracts*, 27th ed. (London, 1994), vol. 1, para. 19-034, at pp. 977 to 978; other cases recognizing the validity of a security interest in receivables after bankruptcy can be distinguished and are not identified here. As to the United States law on this issue, see § 9-408, Official Comment, para. 7.

of asset. Implicit in this approach is the concern that investors who provide secured financing to a business would have an inappropriate degree of influence over the way in which that business is conducted or that licence is used. This concern ignores the commercial reality that investors who are willing to provide unsecured or equity financing to a business often enjoy significant influence over the way in which a business is operated, whether or not that business uses non-transferable licences.

However, there may be a significant public policy reason for not recognizing the creation of a security interest in a licence the transfer of which is prohibited by statute. This is particularly so where the licence has been issued by government. This public policy reason may be more significant for some types of governmental licences (*e.g.* a licence to practice medicine) than is the case for other types of governmental licences (*e.g.* some types of quotas or licences that are "bought and sold" with the approval of governmental regulators despite a statutory prohibition against transfer; in these cases, the regulator cancels the seller's licence and issues a new licence to the buyer).

VI. THE STUDY COMMITTEE'S TENTATIVE CONCLUSION

The Study Committee has tentatively concluded that the law should recognize the validity of the security interest in all licences despite terms in the licence or in applicable law that prohibit the transfer of, or the creation of a security interest in, the licence.

This conclusion is predicated on the assumption that the law will also ensure that the interests of the licensor are not adversely affected. The Study Committee is currently undecided as to whether a licensor should be precluded from terminating a licence where the licensee grants a security interest in violation of the licence terms or applicable law.

VII. ENFORCEMENT RIGHTS AND PROTECTION OF LICENSOR

Where a licence constitutes "personal property" and the law recognizes the validity of a security interest in that licence, to what extent may the secured party enforce its security interest in the licence? This question is answered in at least three different ways in different jurisdictions.

As noted above, the Saskatchewan PPSA empowers a secured party to seize a licence by giving notice to the debtor (*i.e.* the licensee) and the licensor;[27] but the Act stipulates that the licensee's rights may be disposed of only in accordance with the terms and conditions under which the licence was granted or which otherwise pertain to it.[28] It is not clear whether the Saskatchewan PPSA would permit the secured creditor to use the licence – *e.g.* by appointing a receiver-manager to carry on the business of the debtor where the secured party has a security interest in all of the undertaking, property and assets of the debtor.[29] As noted above, it is also not clear whether the licensor would be permitted to terminate the licence where a security interest has been created in violation of the licence terms or applicable law.

Other PPSAs (such as Ontario) are silent on the enforcement issue. In the Study Committee's view in these other jurisdictions (such as Ontario) a secured party would acquire no better rights to dispose of the licence than are enjoyed by the licensee. As to the secured party's right to use the collateral and the licensor's right to terminate the licence, these other PPSAs are at least as unclear as the Saskatchewan PPSA.

As noted above, Article 9 provides more guidance than the Saskatchewan PPSA or other PPSAs. Article 9 ensures that the rights of the licensor are not adversely affected by the security interest by expressly providing that the security interest does not entitle the secured party to use the debtor's rights under a licence nor entitle the secured party to enforce the security interest in a licence.[30]

PLEASE OFFER YOUR VIEWS ON THE QUESTIONS RAISED IN THIS PAPER BY SUBMITTING YOUR RESPONSE TO THE QUESTIONNAIRE.

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[27] Section 57(3).

[28] Section 59(18).

[29] There is nothing in the Saskatchewan Act to preclude giving a receiver the power to exercise rights under a licence unless the licence prohibited this. Section 64(2) recognizes a general power to provide for the appointment of a receiver and to specify the receivers rights and duties consistent with the general provisions of the Act.

[30] § 9-408(d), paras. (4) and (6); as noted above, § 9-408(a) and 9-408(c) preclude the licensor from terminating the licence based on a breach of a term in licence or in applicable law prohibiting the transfer of, or the creation of a security interest in, the licence.