

May 15, 2020

## Rules for Control of Electronic Chattel Paper - Ontario's Push to Modernize the *Personal Property Security Act*

On May 29, 2019, the Ontario government passed amendments to the *Personal Property Security Act* (the "**PPSA**")<sup>1</sup> to modernize the Province's chattel paper regime by introducing provisions to govern the use of electronic chattel paper. The amendments were a reprieve for automotive and equipment dealers, financiers, and other secured parties who had toiled for countless years with the burden of drafting, executing, storing and transferring physical chattel paper. On **Friday, May 15, 2020**, the electronic chattel paper amendments finally came into force.

### What is Chattel Paper?

The PPSA defines 'chattel paper' as a "record that evidences both a monetary obligation and a security interest in or a lease of specific goods."<sup>2</sup> It is thus, in its simplest form, an instrument that reflects both (i) a monetary obligation and (ii) a secured interest in some tangible good. Common forms of chattel paper include leases for personal property, chattel mortgages and conditional sales contracts (each a "**Chattel Paper Document**"), all of which evidence the monetary obligations of the lessee/purchaser, and establish the secured interest of the lessor/vendor in the subject property.

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<sup>1</sup> RSO 1990, c P.10.

<sup>2</sup> PPSA, *supra* note **Error! Bookmark not defined.**, s 1(1).

It is important to note that while a security interest is created under the terms of the Chattel Paper Document, a separate and distinct security interest in the actual Chattel Paper Document is also created upon its transfer to a third party. For example, in a typical automotive dealer financing, a security interest in the motor vehicle is created under the terms of the lease or conditional sales contract in favour of the lender. Upon the sale or transfer of the Chattel Paper Document to a third party, a separate and distinct security interest in that Chattel Paper Document is taken by the third party purchaser of the Chattel Paper Document.

## The Amendments

Until the implementation of the amendments, the PPSA only contemplated the use of physical chattel paper. The amendments introduce new provisions distinguishing electronic and physical chattel paper, and addressing conflicts of laws, perfection and priority issues.

### *Types of Chattel Paper*

The amendments bifurcate chattel paper into two distinct types by adding new definitions for “electronic chattel paper” and “tangible chattel paper”. The former is defined as “chattel paper created, recorded, transmitted or stored in digital form or other intangible form by electronic, magnetic or optical means”, and the latter is defined as “chattel paper evidenced by a record or records consisting of information inscribed on a tangible medium.”

### *The Electronic Regime*

The amendments also include new provisions regarding conflict of laws, attachment, perfection, and priority, resulting in electronic chattel paper being treated similarly to other forms of intangible collateral. The rules governing tangible chattel paper remain, for the most part, the same. The amendments introduce the following rules for electronic chattel paper:

#### *Perfection by Control*

Perfection of a security interest in electronic chattel paper occurs when the secured party has *control* of it. New section 1(3) of the

PPSA outlines the six elements required to perfect an interest in electronic chattel paper by control. A secured party is considered to have control of electronic chattel paper if the record comprising it is created, stored, and transferred in a manner such that:

- a) a single authoritative record of the electronic chattel paper exists that is unique, identifiable and, except as otherwise provided in (d), (e), and (f), unalterable;
- b) the authoritative record identifies the secured party as the transferee of the record;
- c) the authoritative record is communicated to and securely maintained by the secured party or the party's designated custodian;
- d) copies of or amendments to the authoritative record that add or change an identified transferee of the authoritative record can be made only with the consent of the secured party;
- e) each copy of the authoritative record and any copy of a copy is readily identifiable as a copy that is not the authoritative record; and
- f) any amendment of the authoritative record is readily identifiable as to whether it is authorized or unauthorized.

### *Priority*

Section 28(3) of the PPSA establishes priority rules in respect of ordinary course purchases of tangible and electronic chattel paper. Prior to the amendments, a purchaser of (tangible) chattel paper who took possession of it in the ordinary course of its business and for new value, would have priority over any security interests perfected by registration so long as the purchaser did not have knowledge of the existing security interests.

The amendments repealed the aforementioned knowledge rule. Now, a purchaser of tangible chattel paper, who, in the ordinary course of its business, and for new value, takes *possession* of the tangible chattel paper, will have priority over any other security interest in

such chattel paper, so long as the chattel paper does not indicate that it has been assigned to another identifiable assignee. Likewise, a purchaser of electronic chattel paper, who, in the ordinary course of its business, and for new value, obtains *control* (subject to the requirements of section 1(3) described above) of the electronic chattel paper, will have priority over any other security interest in such chattel paper, so long as the chattel paper does not indicate that it has been assigned to another identifiable assignee.

The new priority rules described above are subject to the exception contained in new section 28(3.1). Section 28(3.1) establishes a priority rule as between owners of duplicative chattel paper that exists in both electronic and tangible forms. In the event that tangible chattel paper is transferred to a purchaser as electronic chattel paper (for value and in the ordinary course of the purchaser's business), and the same tangible chattel paper is transferred to a different purchaser as tangible chattel paper (for value and in the ordinary course of the purchaser's business), the purchaser of the tangible chattel paper will have priority over the purchaser of the electronic chattel paper so long as the former has possession of the tangible chattel paper, and the tangible chattel paper does not indicate that it has been assigned to another identifiable assignee.<sup>3</sup> It is therefore incumbent upon purchasers of electronic chattel paper which originated as tangible chattel paper to confirm that the tangible document has been marked to note the assignment and the name of the assignee.

#### *Conflict of Laws*

The amendments also include separate conflict of laws provisions for tangible and electronic chattel paper. The validity, perfection, effect of perfection or non-perfection of a possessory security interest in tangible chattel paper continues to be governed by the laws of the jurisdiction where the tangible chattel paper is located at the time of attachment.<sup>4</sup> A non-possessory security interest in tangible chattel paper continues to be governed by the laws of the jurisdiction where

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<sup>3</sup> PPSA, *supra* note **Error! Bookmark not defined.**, s 28(3.1).

<sup>4</sup> PPSA, *supra* note **Error! Bookmark not defined.**, s 5(1).

the debtor is located at the time of attachment.<sup>5</sup> A security interest in electronic chattel paper will be governed by the laws of the jurisdiction where the debtor is located at the time of attachment.<sup>6</sup>

### Implications for Dealers and Financial Institutions

Automobile and equipment dealers, consumers, financiers and others who deal in chattel paper stand to benefit immensely from the introduction of electronic chattel paper. The prior physical possessory requirements imposed significant administrative and monetary costs due to the expense of management and storage of large volumes of original physical documents. With the introduction of electronic chattel paper, the ability to rely on electronic records in lieu of physical paper will greatly reduce or eliminate many of these costs.

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#### a cautionary note

The foregoing provides only an overview and does not constitute legal advice. Readers are cautioned against making any decisions based on this material alone. Rather, specific legal advice should be obtained.

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<sup>5</sup> PPSA, *supra* note **Error! Bookmark not defined.**, s 7(1).

<sup>6</sup> *Ibid.*