THE PPSA AND LEASES OF PERSONAL PROPERTY

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1.0 INTRODUCTION

An area which is of significant interest to finance lawyers is how leases of personal property are dealt with under the Ontario Personal Property Security Act, R.S.O. 1990, c. P.10 (the “PPSA”). The need to be able to analyse and deal correctly with leases under the PPSA has only increased in the past number of years, as leasing has steadily grown as an alternative to bank financing both for consumer purchases of larger items such as cars, as well as for companies’ acquisitions of large ticket items of equipment. As well, transactions involving PPSA-sensitive leasing questions have grown more common as companies have increasingly resorted to sophisticated leasing structures and securitizations in an effort to manage their balance sheets or exposure to certain risks, although the revelations concerning Enron’s accounting practices have dampened enthusiasm for many of the more exotic leasing structures.

2.0 PPSA TREATMENT OF LEASES

2.1 Introduction

Fundamentally, a personal property lease is a contract between two parties, the subject of which is the granting by the lessor to the lessee of an exclusive right to possess and use property in which the lessor has exclusive rights for a specified period of time in return for payments of rent. Presumably, one might think, the PPSA should not be particularly interested in interfering with the bargain struck by a lessor and a lessee with respect to the transfer of the right to possess and use personal property under a lease contract. And one would be right, provided that no other third party had any dealings with the lessor or the lessee or any expectations about the lessee’s property. However, because a lease has the peculiar characteristic of transferring possession and use of property, and therefore economic value, to the lessee, while preserving legal title to such property with the lessor, it has the potential to skew what would otherwise be the fair treatment of third party creditors of a lessee. It is this potential for unfair treatment which the PPSA attempts to address and prevent.

2.2 Leases of Real Property

It should be noted at the outset that this paper does not deal with leases of real property or with leases of personal property which become fixtures attached to real property. Leases of real property are excluded from the ambit of the PPSA, as the creation, registration and transfer of
interests in real property are governed entirely by the *Land Titles Act*, R.S.O. 1990, c. L-5 and the *Registry Act*, R.S.O. 1990, c. R-20. As section 4(1)(e) states, the PPSA does not apply,

(e) to the creation or assignment of an interest in real property, including a mortgage, charge or lease of real property, other than,

(i) an interest in a fixture, or

(ii) an assignment of a right to payment under a mortgage, charge or lease where the assignment does not convey or transfer the assignor’s interest in the real property.

Thus, although the PPSA would apply to an assignment by a lessor/debtor of the bare right to be paid under a lease of real property – i.e. the lease receivables or rents – any aspect of an assignment of an interest in a lease of real property which would have the effect of transferring an interest in the underlying real property would be excluded from the scope of the PPSA.\(^1\)

As well, the PPSA sets out a regime for sorting out competing interests in fixtures as between landlords and creditors of tenants/debtors. As the PPSA’s regime regarding fixtures is outside the scope of this paper, the reader is directed to the discussion of this regime in the paper regarding fixtures being presented at this conference.

2.3 Leases of Personal Property

(i) True Lease v. Disguised Financing

Leases are strange creatures which exist on a spectrum between two distinct poles. At one end of the spectrum, a lease can constitute nothing more than a bare agreement to possess and use another person’s property for a limited period of time in exchange for rent in an amount much less than the value of the property. In this case, neither the lessor nor the lessee expect that the lessee will acquire title or interest in the leased property and therefore the lease itself is not a mechanism for securing the obligation of the lessee in this regard. At the other end of the spectrum, a lease can be structured as a form of financing, where the rents paid under the lease are equivalent to the principal and interest payments which the lessee would otherwise have paid to the lessor had the lessee borrowed money from the lessor in order to acquire the property. In this case, the title retention mechanism of the lease is used to secure the obligations of the lessee.

(ii) True Lease v. Financing Lease Analysis

A threshold question which must be asked when determining how the PPSA deals with leases is whether it applies to them at all. As mentioned above, the underlying rationale of the

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1 See PPSA, s. 36 regarding priority rules in respect of security interests in payments owing under real property leases and mortgages.
PPSA’s treatment of leases is to ensure that the structural peculiarities of leases are not used in such a way so as to permit lessors and lessees/debtors to treat third party creditors unfairly. The way in which the PPSA accomplishes this goal is to remove the formal aspects of the lease relationship from its analysis in order to focus on the substantive aspects of the contractual relationship between lessors and lessees so that parties who structure a financing in the form of a lease are treated the same as those who choose a more traditional form such as a loan and security agreement. As the Ontario Superior Court of Justice stated in one of the seminal cases regarding lease analysis, \textit{Re Speedrack Ltd.},

\begin{quote}
[i]t is not merely a question of construing the agreement between the parties which may be quite clear. It is a question of determining the intention of the parties, notwithstanding the form used in setting up the transaction . . . .The Court’s task is to determine the essence of the transaction in spite of its form. It must determine, on a balance of probabilities, and on a practical common-sense view of the evidence, whether the parties negotiated a loan or an advance on security, or a standard lease of property . . . .\end{quote}

This approach is reflected in section 2 of the PPSA, which sets out the types of transactions to which the PPSA applies. Section 2 states that:

Subject to subsection 4(1), this Act applies to,

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  \item[(a)] every transaction without regard to its form and without regard to the person who has title to the collateral that in substance creates a security interest including, without limiting the foregoing, . . . .
  \item[(ii)] an assignment, lease or consignment that secures payment or performance of an obligation.\end{itemize}

Thus, if a lease does not secure the payment or performance of an obligation, it will not fall within the scope of the PPSA and will not be viewed as constituting a security interest in the subject property. That is, if the lessor and the lessee intend that, under the lease, the lessee will only have the right to possess and use the property of the lessor for a limited period of time in exchange for rent, and then be obliged to return it at the end of the lease term without any expectation of acquiring some interest in the property, the lessor will not have to perfect a security interest in the leased property in order to assert its prior and exclusive right to the

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\item[3] It should be noted that every PPSA jurisdiction in Canada other than Ontario to a large extent does away with the true lease v. financing lease analysis by simply deeming any lease of more than one year a security agreement for the purpose of their PPSA. There appears to be a good chance that Ontario will move towards this model in the future.
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property against creditors of the lessee or a trustee in bankruptcy. Leases having this nature are often referred to as “true leases”.

However, if in substance the title retention mechanism of a lease is intended to secure the payment by a lessee/debtor of what would otherwise be the financed purchase price of the property, then the PPSA will apply to the transaction and, in effect, deem that the lessor of such property did not retain a simple ownership interest in such property, but rather conveyed title to such property to the lessee/debtor while retaining a security interest therein. In this case, the lessor of the property will have to perfect its interest in the property under the PPSA in order to claim priority to such property as against third party secured creditors or trustees in bankruptcy.\(^4\)

Unfortunately, the PPSA is not overly-helpful in providing indicia as to what type of leases constitute true leases and what type constitute financing leases. This, of course, is quite deliberate on the part of legislators, who do not wish to set out rigid tests which then become quite easy to structure around with a view to avoiding the intended effect of the PPSA. The job of developing tests for sorting out true leases from financing leases, therefore, has fallen to the courts. Even the courts, however, have not developed hard and fast rules in this regard. This has partly been for reasons similar to those ascribed to legislators above, but even more so because, as mentioned, leases tend to exist on a continuum between the poles of being a true lease and being a financing lease: most often they contain characteristics of each type, even though they may lean toward or be intended as one or the other. In determining, whether, in essence, a lease constitutes a financing arrangement, the court will generally consider role of the parties, the intent of the parties and the effect of the lease transaction\(^5\) in order to determine “whether the transaction as a whole, in substance creates a security interest.”\(^6\)

Over the years, however, the courts have developed a number of more specific indicia to help them analyse whether particular leases constitute financing arrangements or are, in fact, true leases. In particular, the following characteristics have proved relevant to this determination:

(a) **Business of Lessor.** If the lessor is the supplier of the leased property (i.e. the lessee did not purchase the property from a third party and sell it to the lessor), maintains an inventory of similar property for lease (i.e. the lessor did not acquire the property after the lease was entered into) and normally is in the business of leasing such property, then the lease in question is more likely to be viewed as a true lease.\(^7\) Factors such as whether the lessee selected the property to be leased, whether the lease was executed prior to

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\(^4\) PPSA, s. 20(1) states that an unperfected security interest is not effective against, among others “a person who represents the creditors of the debtor, including an assignee for the benefit of creditors and a trustee in bankruptcy.”

\(^5\) See Speedrack, supra note 2.


\(^7\) Adelaide Capital, supra note 6.
the purchase of the property and whether the lessor failed to provide any representations or warranties regarding the property tend to reinforce the view that the lease under scrutiny is in the nature of a financing lease.

(b) Treatment of Transaction by Lessor. A lease may be characterised as a financing lease if there is evidence that the lessor has treated the lease internally as a form of financing; that is, if the lessor accounted for the rental payments in terms of principal, interest and yield on its investment or if it was able to fix at the commencement of the lease the minimum amount that it would be repaid in respect of the leased property (i.e. if, upon the return of the property, the lessee would be responsible for any deficiency realised upon the sale of such property below a specified residual value).8

(c) Incidents of Ownership. In a true lease, title to the property remains with the lessor. Such a provision, however, is also common in financing leases, and therefore cannot be viewed as determinative. Rather, courts tend to consider whether all or substantially all of the benefits and risks of ownership of the leased property are transferred to the lessee pursuant to the lease. Factors which courts take into consideration in this regard are things such as whether the lessee has the obligation to maintain and repair the property, whether the lessee is liable for all taxes to be paid in connection with the property and whether the lessee must insure the property for its full replacement value.9

(d) Option to Purchase. If a lease grants to the lessee an option to purchase the subject property at a price at which no reasonable lessee would refuse to exercise such option, the courts may find that the intention of the parties was that the lessee would ultimately own the property and, in effect, pay for it through its rent payments.10 Thus, for example, in a financing lease, the lessee may be granted the option to purchase the property for an amount that is less than the fair market value of the subject property or at an amount equal to the unamortized portion of the cost of the property. Conversely, if the lessee is granted an option to purchase the property at the anticipated fair market value of the property at the option date, such purchase option is more likely to be viewed as evidencing a true lease.11 The fact that an agreement

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8 Adelaide Capital, supra note 6.
contains a fair market value purchase option or even does not contain a purchase option, however, should not be taken as determinative of the nature of the agreement, as courts also consider other, extrinsic factors to assess the economic substance of a transaction.

(e) **Length of the Lease Term.** If the length of the lease term is for all or substantially all of the economic life of the leased property, this may indicate that the lease is in substance a financing arrangement, since it would be unlikely that the lessor would reclaim the property after the expiry of the lease.

(f) **Correlation of the Aggregate of the Lease Payments with the Value of the Property.** If the aggregate of the rent payments payable over the term of the lease corresponds closely with the value of the leased property, together with financing charges, this tends to indicate that the lease may be in the nature of a financing lease.\(^\text{12}\)

(g) **Acceleration Clause.** If in the event of a default under the lease the lessee is obligated to pay all amounts owing under the lease for the full term including the residual value of the leased property at the end of the term, then the lease is more likely a financing lease.

It should be stressed that none of the above-noted criteria are sufficient in isolation to determine whether a particular agreement is a true lease or a financing lease. Indeed, it is worth repeating that a particular agreement may contain characteristics which both support and detract from the view that it is of one type or another. The main point of the analysis, however, is to determine, based on a weighing of how these characteristics are evidenced by the transaction taken as a whole, whether the intent of the parties and the effect of the transaction was to secure the payment or performance of an obligation.

(iii) **Implications of True Lease v. Financing Lease Determination**

If a lease in question is not a financing lease but rather a true lease, then the lessee of the leased property never acquires any title or equity in or to such property. Accordingly, the leased property cannot be made subject to the liens of third party creditors of the lessee, as the lessee would not have sufficient rights in such property to permit a security interest to attach. As well, in a bankruptcy situation, such property would not pass into the estate of a bankrupt lessee because, as a general rule, the trustee in bankruptcy only steps into the shoes of the bankrupt and does not gain any higher or greater rights than the bankrupt: as such, the trustee could not assert

a higher interest than the lessor to the leased property. In this situation, the property would be returned to the lessor as the rightful owner.

If a lease constitutes a financing arrangement, however, then all of the requirements for perfection and the determination of priorities under the PPSA come into play. Thus, for example, if the lessor did not perfect its interest in the leased property in accordance with the PPSA, then its interest in the property is subordinate to a third party secured creditor whose perfected security interest extends to such property and is not effective against a trustee in bankruptcy. In other words, the lessor would almost certainly lose the property. Conversely, if the lessor did perfect its security interest in the leased property, then, provided there is no prior-ranking secured creditor with a prior-ranking perfected security interest in the same property (which will not often be the case, given that most often financing leases give rise to purchase money security interests, as discussed in Section 3.0 of this paper), it will have available all of the remedies set forth in the lease agreement regarding the repossession and realisation of the property as well as the remedies set out in Part V of the PPSA.

3.0 REGISTERING LEASES UNDER THE PPSA

3.1 PMSI Security in Leased Property

A discussed above, a lease which is in the nature of a financing must be registered in order for the lessor to perfect its security interest in the leased property. Financing leases tend to fall within the definition of purchase-money security interests ("PMSIs") under the PPSA, as the lessor in such situations is usually entering into the transaction for the purpose of financing specific property which it is supplying to the lessee. As such, PMSI super-priority under section 33 of the PPSA is potentially available to the lessor provided it complies with the requirements and the time periods set forth in such section regarding the perfection of PMSIs. (It should be noted, however, that sale-leaseback transactions are explicitly excluded from the definition of PMSI under the PPSA and, therefore, PMSI super-priority will not be available in connection with transactions of that nature.) Care should be given to determine whether the property in the hands of the lessee constitutes inventory under the PPSA so that the extended requirements for perfecting a PMSI in inventory under section 33 are satisfied: as discussed below in Section 3.4 of this paper, property which is characterised as equipment in the hands of the lessor can in some circumstances be characterised as inventory in the hands of the lessee.

13 PPSA, s. 20(1)(a)(i).
14 PPSA, s. 20(1)(b).
15 Section 1(1) of the PPSA defines a “purchase-money security interest” as “(a) a security interest taken or reserved in collateral to secure payment of all or party of its price, or (b) a security interest taken by a person who gives value for the purpose of enabling the debtor to acquire rights in or to collateral to the extent that the value is applied to acquire the rights, but does not include a transaction of sale by and lease back to the seller.”
3.2 Precautionary Registrations

In light of the potential ambiguity with respect to the characterisation of leases, it is advisable to register a financing statement against the lessee in situations where there is uncertainty as to whether a lease constitutes a financing arrangement. The parties need not worry that registering a financing statement in connection with the transaction will prejudice the determination of the transaction. As section 46(5) of the PPSA provides,

46. (5) Effect of Registration – Registration of a financing statement or a financing change statement,

(b) does not create a presumption that this Act applies to the transaction to which the registration relates.

This rule, of course, is in keeping with the approach of the PPSA, which prefers a substantive analysis to a formal one when determining whether a lease constitutes a true lease or a financing arrangement: on this view, the mere registration of a financing statement in respect of the transaction should not affect the substantive analysis.

3.3 Contingent Grants of Security

As a further added precaution to guard against a court’s determination that a lease intended to be a true lease actually constitutes a financing arrangement, one can add language to a lease which provides that even though the lease is intended to be a true lease, if a court were to determine that it is in fact a financing lease, then a security interest in the leased property would be granted to the lessor with the intention that such security interest would attach at the time the lease was executed. An example of such language is as follows:

Grant of Security Interest

(a) Although the parties agree that the legal title to the leased property shall be and remain in the Lessor, in order to effectively protect the interest of the Lessor in the leased property in the event that this Lease is determined by a court of competent jurisdiction to be a “financing lease” or a lease intended as security for the purposes of applicable personal property security legislation, the Lessee hereby assigns, grants and pledges to the Lessor a security interest in all of the Lessee’s right, title and interest, whether now or hereafter existing or acquired, in the leased property, to secure the payment and performance of all obligations of the Lessee now or hereafter existing under this Lease.

(b) The foregoing security interest is granted as additional security to ensure the full protection of the rights and interests of the Lessor in the leased property and under this Lease. The creation of the foregoing security interest in favour of the Lessor shall not be interpreted nor construed as a
negation of or as affecting in any manner any rights, interests and
recourses of the Lessor under this Lease nor the Lessor’s absolute right of
ownership in the leased property as acknowledged and recognized in this
Section. Without limiting the scope of the foregoing, it is understood that
the foregoing security interest will affect the leased property from the date
the Lessee acquires or is deemed to have acquired any rights or interests of
any nature in the leased property for any reason and under any
circumstances whatsoever.

The purpose of this language is to forestall any argument by another secured creditor or trustee in
bankruptcy that, even though the lessor may have filed a cautionary registration in order to
protect against the contingency that the lease was found to constitute a security agreement, a
perfected security interest in the property never arose because the security interest never attached
to the leased property.16

3.4 Collateral Classifications

Because a lease is invariably a lease of specific property, it is common practice to select
only the specific collateral classifications which relate to such property when registering a
financing statement in connection with a lease, rather than selecting all of the collateral
classifications as in the case of a grant of general security.

Where the lessee is a corporation or other business entity, the collateral classifications
most likely will be “Equipment” and “Inventory.” The PPSA definition of “equipment” is a
broad one, providing simply that “equipment” means “goods that are not inventory or consumer
goods.” Thus, if a business leases property that it merely intends to use in its operations (for
example, manufacturing equipment, photocopiers, dump trucks, computers or telephone
systems), then the lessor would need to select only the collateral classification for “Equipment.”

If, however, a business leases property and, in addition to using it in its operations, sub-
leases the property to others, then such property falls within the definition of “inventory” under
the PPSA, which is “goods that are held by a person for sale or lease or that have been leased or
that are to be furnished or have been furnished under a contract of service, or that are raw
materials, work in process or materials used or consumed in a business or profession.” [emphasis
added] It is worth noting that the definition of “inventory” includes goods that “have been
leased,” which raises the possibility that property which the lessee is currently using as
equipment in its own operations may nevertheless be open to characterisation as “inventory”
because they have been sub-leased by the lessee at some point. In this light, ample consideration
should be given by the lessor as to whether it should select the collateral classification for
“Inventory” when it is filing its financing statement against the lessee.

16 See sections 11(1) and 11(2) of the PPSA for the rules governing the attachment of security interests.
As well, care should be taken to check off the “Motor Vehicle Included” box where motor vehicles are included in the property leased to the lessee, as required by section 3(1)(g) of the PPSA’s General Regulation, R.R.O. 1990, Reg. 912 (the “Regulations”). Under the Regulations, a “motor vehicle” is defined as:

an automobile, motorcycle, motorized snow vehicle or any other vehicle that is self–propelled but does not include,

(a) a street car or other vehicle running only upon rails,
(b) a farm tractor,
(c) an implement of husbandry,
(d) a machine acquired for use or used as a road-building machine, or
(e) a craft intended primarily for use in the air or in or upon the water.

Section 3(8) of the Regulations provides that it is not mandatory to describe a motor vehicle which is not consumer goods by vehicle identification number (“VIN”), model year, model, make or manufacturer in the financing statement, although such information may be included. However, it should be noted that if a motor vehicle forms part of the collateral, then if the vehicle’s VIN is not included in the financing statement, the lessor may lose priority to a purchaser who buys the motor vehicle from the lessee in certain circumstances.17

Where the property leased to the lessee constitutes “goods that are used or acquired for use primarily for personal, family or household purposes,” then such property is classified as “consumer goods” under the PPSA and must be so indicated on the financing statement (which should not be registered until the lessee has signed the lease, as required by section 45(2) of the PPSA). If all of the property leased to the lessee is classified as consumer goods, then under section 3(1) of the Regulations, the financing statement registered with respect to such goods must include the principal amount of the loan and its maturity date or, if there is no fixed maturity date, an indication that there is no fixed maturity date. As well, if the property classified as consumer goods includes a motor vehicle, the lessor must describe the motor vehicle by VIN, model year (if any), model (if any) and the make or the name of the manufacturer.18

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17 See s. 28(5) of the PPSA regarding sales of motor vehicles classified as equipment of the seller out of the ordinary course of business of the seller.

18 Regulations, ss. 3(7) and (9).
3.5  Limiting the Scope of the Security Interest

Given that leases invariably concern leases of specific property, it is generally viewed as good practice to limit the registration by including a collateral description with enough specificity that subsequent secured lenders do not require acknowledgements and confirmations of security interests when completing their transactions. In keeping with the PMSI nature of interests in personal property under leases, lessors generally do not expect to obtain security in assets of lessees other than the property subject to the lease: where a lessor expects collateral security to secure the obligations of the lessee under the lease, it generally will enter into a separate agreement with the lessee in this regard. Accordingly, most lessors are open to the idea of limiting the scope of their security interest through the use of a specific collateral description; indeed, many of the more sophisticated lessees and lessees with greater bargaining power will insist upon it. Care should nevertheless be taken to ensure that the specific collateral description is drafted in such a way that does not exclude important parts or aspects of the leased property. The following is an example of a collateral description used in connection with the lease of an aircraft (which are highly modular and constantly having parts taken off and reinstalled):

Pursuant to a lease agreement made as of [Date], between [Debtor Name], as Lessee, and [Secured Party Name], as Lessor (as amended from time to time and including any annex, supplement or schedule thereto) (the “Lease”), an Airbus [Make and Model Number] aircraft bearing manufacturer’s serial number ●, and Canadian registration mark ●, respectively (the “Aircraft”), including all engines installed on or furnished therewith and any replacement engine which may from time to time be substituted therefor, together with any and all parts incorporated therein or attached thereto and any and all parts removed therefrom so long as title thereto remains vested in Lessor pursuant to the Lease (collectively, the “Engines”), and any appliance, component, part, appurtenance, accessory, auxiliary power unit, instrument, navigational and communications equipment, furnishing, seats, module, component and other parts and equipment which may be incorporated or installed on attached to the Aircraft or any Engine from time to time or which are removed from the Aircraft or any Engine so long as the same remains subject to the Lease and spare parts and/or ancillary and loose equipment and devices relating thereto (collectively, the “Parts”), and all the logs, records, manuals, specifications and other documentation pertaining to the Aircraft, delivered with the Aircraft or generated during the term of the Lease, and such other items or documents which may be acquired or prepared by Lessee, or by any other person relating to the use, operation, service, inspection, storage, overhaul and maintenance of the Aircraft, and all additions, substitutions, renewals and replacements from time to time made in or on the said Aircraft, Parts and Engines, whether or not for the time being installed on or in the airframe forming part of the Aircraft so long as the same remains subject to the Lease, and the proceeds of any sale, assignment or other disposition of any of the foregoing, any claim resulting from such a sale,
assignment or other disposition, as well as any property acquired in replacement thereof or as consideration therefor, and all present and future indemnities or proceeds of insurance or expropriation payable in respect of any of the foregoing.

It should be noted, however, that the scope of the lessor’s security interest will only be limited with respect to those collateral classifications which are referenced in the general collateral description. As section 46(3) of the PPSA provides,

> Except with respect to rights to proceeds, where a financing statement or financing change statement sets out a classification of collateral and also contains words that appear to limit the scope of the classification, then, unless otherwise indicated in the financing statement or financing change statement, the secured party may claim a security interest perfected by registration only in the class as limited.

Careful consideration should therefore be given as to which collateral classifications are effectively limited by the language used in the general collateral description.

### 3.6 Best Practices

(a) Regardless of whether the parties believe that the lease is a true lease or a financing lease, the lessor should register a financing statement against the lessee for the lease term plus two years (to take account of any lease term extensions or the time of any realisation procedures): because it does not give rise to a presumption that the PPSA applies to the lease, the lessor loses nothing by making the registration and potentially gains a great deal.

(b) The lessor should ensure that all of the requirements and time periods are met to ensure that it acquires PMSI super-priority with respect to the leased property.

(c) The lessor should try to include language in the lease which contingently grants a security interest in the leased property if the lease is found to be a financing arrangement.

(d) The lessor should try to limit the registration as much as possible to the property actually being leased: this will save the lessor future trouble and aggravation from subsequent secured lenders requesting acknowledgements of the limited scope of the lessor’s security interest in the lessee’s property. However, the lessor should make sure that any specific collateral description is broad enough to encompass all of the leased property.

(e) If the lessee holds the leased property for further sub-lease or has sub-leased the property in the past, this may constitute inventory in their hands and therefore
“Inventory” should be checked off in the collateral classification boxes in the financing statement.

(f) If the leased property is or includes a motor vehicle which is not consumer goods, the lessor should provide the VIN in the financing statement in addition to checking off “Equipment” and “Motor Vehicles Included” in order to avoid losing priority to third party purchasers of the vehicle from the lessee.

(g) If the leased property is classified as consumer goods, the lessor should ensure that the information required by section 3(1) (and section 3(7) in the case of motor vehicles) of the Regulations is included in the financing statement and that the financing statement is registered after the lease is signed by the lessee in accordance with section 45(2) of the PPSA.

4.0 DEALING WITH SUB-LEASES

4.1 Sub-leases

Leases will often provide that a lessee has the right to sub-lease the property subject to the lease between the lessee and the lessor (the “Head Lease”). Lessors will often insist, as a condition of their consent to a lease of such property from the lessee to a sub-lessee (the “Sub-lease”), that a term be included in the Sub-lease which provides that if a default has occurred under the Head Lease or if the Head Lease has been terminated, then a default will be deemed to have occurred under the Sub-lease or the Sub-lease will be deemed to have been terminated, as the case may be. This allows the lessor to roll up the entire Head Lease and Sub-lease structure if need be. However, this right is merely a contractual right and, if the Sub-lease in question is in the nature of a financing arrangement, the lessor will find that its interest in the sub-leased property will be subordinated to other secured creditors or a trustee in bankruptcy unless a security interest in such property has been properly perfected in accordance with the PPSA.

4.2 Registrations Against Sub-lessee

In the case of Sub-leases, all of the same considerations as to the advisability of registering a financing statement and the best practices which were discussed in Section 3.0 of this paper will apply. The basic structure of a registration in respect of a Sub-lease is a registration by the lessee against the sub-lessee with respect to the leased property. This registration ensures that the lessee’s interest in the sub-leased property is perfected and therefore protected against secured creditors and trustees in bankruptcy. Given that there is no direct privity between the lessor and the sub-lessee, the lessor’s interest in the sub-leased property is derivative through the lessee’s rights under the Sub-lease; as such, it is often desirable that the lessor be actively involved with and review the registrations made against the sub-lessee in respect of the sub-leased property.
4.3 Security Interest in Sub-Lease

Lessors will often wish to have further protection of their rights to the sub-leased property by taking a security interest in the Sub-lease itself. This ensures that, if the lessee defaults under the Head Lease, the lessor can step into the shoes of the lessee in relation to the Sub-lease and continue to sub-lease the property to the sub-lessee for its own direct benefit, while removing the lessee from the equation. Registering security interests in leases themselves is discussed in more detail below in Section 5.0 of this paper.

4.4 Addition of Lessor as a Secured Party

Because, even in the case where a lessor has taken a security interest in the Sub-lease, a lessor’s rights are derivative of and reliant upon, to a certain extent, the actions of the lessee, a lessor may wish to be added as an additional secured party in the registration against the sub-lessee. This not only has the effect of ensuring that the sub-lessee has notice that the lessor has an interest in the sub-leased property, but it also ensures that the lessor will receive notice of any modification or discharge of the registration against the sub-lessee (otherwise, the lessor is merely relying upon the covenant of the lessee that it will maintain the registration of its security interest against the sub-leased property which, if the lessee becomes bankrupt, may not be worth a great deal). Thus, while not enhancing any of the legal rights of the lessor against the sub-lessee, adding the lessor as an additional secured party to the registration made against the sub-lessee makes it harder for actions to be taken with respect to the security interest in the sub-leased property which might jeopardise the lessor’s ultimate interest in such property without the lessor’s knowledge.

4.5 Best Practices

(a) The lessor should ensure that the lessee registers a financing statement against the sub-lessee, particularly where there is some uncertainty as to the characterisation of the lease. The lessor should also ensure that the lessee selects that appropriate collateral classifications in such financing statement to ensure that the security interest in the sub-leased property is perfected.

(b) The lessor should ensure that it is added as an additional secured party to the registration against the sub-lessee in order to provide notice to the sub-lessee of the lessor’s interest in the leased property and to ensure that the lessor receives notice of any modification or discharge of the registration.

(c) The lessor should consider amending its registration against the lessee in respect of the Head Lease to add “Inventory” as a collateral classification if it was not selected at the time of the initial registration.

(d) The lessor should consider obtaining an assignment of the Sub-lease so that, upon a default under the Head Lease, it can step into the shoes of the lessee vis-à-vis the Sub-lease.
5.0 SECURITY INTERESTS IN LEASES

5.1 Assignments of Leases

As discussed in Section 4.0 of this paper, lessors will often require lessees to assign as security a Sub-lease of property subject to a Head Lease. Debtors will grant security in leases to secured parties in many other circumstances as well: for example, where a debtor is borrowing money on the basis of rent receivables derived from a portfolio of personal property leases. It is advisable when taking a security interest in leases to also take a security interest in the underlying property which is subject to the lease.

5.2 Registration of Assignments of Leases

(i) Collateral Classification

A secured party taking security in a lease itself, however, is in a different position from a lessor registering a security interest in property pursuant to a lease. In the former case, the collateral is now the lease rather than the underlying personal property. Under the PPSA, however, a lease comes within the scope of the definition of “chattel paper”, which is defined as “one or more than one writing that evidences both a monetary obligation and a security interest in or a lease of specific goods.” An “account”, by contrast, is defined as “any monetary obligation not evidenced by chattel paper, an instrument or a security, whether or not it has been earned by performance.” [emphasis added] Therefore, the appropriate collateral classification to select when registering a financing statement in connection with the granting of security in a lease is “Other”.

Further, as mentioned above, the secured party to whom a security interest in a lease is granted will usually also take security in the underlying property which is subject to the lease. Accordingly, the secured party should also select the collateral classification(s) which pertain to the leased property (see Section 3.4 above). It should be noted that, given the property in question has been leased pursuant to a Sub-lease, it is likely that such property will count as “inventory” under the PPSA and therefore care should be taken to ensure that this category is selected as one of the collateral classifications when registering a financing statement in connection with the assignment of lease.

(ii) Jurisdiction of Registration

Under section 7(1) of the PPSA, the validity, perfection and effect of perfection or non-perfection of a non-possessory security interest in a chattel paper is governed by the law of the jurisdiction where the debtor is located at the time the security interest attaches. Accordingly, the financing statement registered in respect of an assignment of lease should be registered in the jurisdiction in which the debtor’s place of business, if there is one, is located, or in which the
debtor’s chief executive office is located if the debtor has more than one place of business, and otherwise where the debtor’s principal place of residence is located.\textsuperscript{19}

(iii) Limiting the Scope of the Registration

If the security interest granted under an assignment of lease is in respect of one or only a few leases, then, for the reasons discussed above, the secured party may wish to consider limiting the scope of its security interest by providing a specific collateral description in the financing statement. The following is an example of a collateral description which might serve to narrow the scope of a security interest granted in respect of a specific lease:

Assignment by [Debtor] of the [Assigned Lease] dated [Date] between [Debtor] and [lessee under Assigned Lease] (hereinafter, the “Assigned Lease”), including all rents and other payments due or accruing due or at any time hereafter to become due from [lessee under the Assigned Lease] pursuant to the Assigned Lease and the benefit of all guarantees of payment and all covenants to pay therein contained.

It should be noted that this collateral description would not serve to limit collateral classification chosen with respect to “Equipment” or “Inventory” if selected in connection with a grant of security in the underlying property subject to the assigned lease.

5.3 Best Practices

(a) The secured party should ensure that the collateral classification “Other” is selected when registering a financing statement in connection with an assignment of lease. If, as is likely, a security interest is also granted to the secured party with respect to the underlying property, the secured party should also ensure that collateral classifications appropriate to such property are selected as well.

(b) The secured party should ensure that, where it is not taking possession of the lease or leases in which security has been granted, that the security interest is registered in the jurisdiction where the debtor is located for the purposes of section 7 of the PPSA. If there is some ambiguity as to where the debtor is located for the purposes of registering the security interest, then the secured party should register in each of the jurisdictions in which it is possible that the debtor is located.

(c) If the security interest is being granted in respect of only one or a few leases, the secured party should consider limiting the scope of the security interest by including a specific collateral description when registering the financing statement in connection with the assignment of lease.

\textsuperscript{19} PPSA, s. 7(4).
6.0 ABSOLUTE ASSIGNMENTS OF LEASES

6.1 Application of PPSA to Absolute Assignments of Leases

Section 2(b) of the PPSA provides that the PPSA applies to “a transfer of an account or chattel paper even though the transfer may not secure payment or performance of an obligation.” In other words, the PPSA applies to an absolute assignment of a lease of personal property (which, as discussed above, comes within the scope of the definition of “chattel paper”). This is potentially relevant in the case of sales of lease portfolios or individual lease transactions, as well as in the case of securitizations of lease portfolios, where leases are sold to a bankruptcy remote entity as part of the transaction. It should be noted that a sale of the property subject to the assigned lease to the assignee of the lease is almost invariably a part of the transaction in which the lease is assigned. As discussed below, in this case, the assignee/purchaser of the lease will want the assignor to assign any security interest it has registered against the lessee in respect of the leased property to the assignee/purchaser so that it can gain whatever priority the assignor currently enjoys with respect to such property.

The manner in which the PPSA applies to absolute assignments of leases is to deem the interest of the assignee of the lease a security interest. Under the PPSA, a “security interest” is defined as,

an interest in personal property that secures payment or performance of an obligation, and includes, whether or not the interest secures payment or performance of an obligation, the interest of a transferee of an account or chattel paper. [emphasis added]

As such, the absolute assignee of a lease must perfect its interest in the lease in accordance with the PPSA. As discussed above, a security interest in a lease can be perfected by possession pursuant to section 22 of the PPSA or by registration pursuant to section 23 of the PPSA. Where numerous originals of a lease agreement may have been signed, however, perfecting by possession may be problematic; therefore, it is generally good practice to register a financing statement in respect of the absolute assignment in order to perfect the assignee’s interest in the lease.

If an absolute assignee of a lease does not perfect its security interest under the PPSA, then it risks losing its priority in and to the lease. As section 20(1)(c) of the PPSA provides that,

until perfected, a security interest in

(c) chattel paper, documents of title, securities, instruments or goods is not effective against a transferee thereof who takes under a transfer that does not secure payment or performance of an obligation and who gives value and receives delivery thereof without knowledge of the security interest.

...
The danger to an absolute assignee of a lease is that, unless it perfects its deemed security interest in the lease/chattel paper by taking possession of it or registering a financing statement against the assignor at the time of the assignment, the assignor of the lease could sell and assign the lease to a third party which does not have knowledge of the interest of the assignee. Once such third party takes delivery of the lease/chattel paper, its own interest in the lease/chattel paper would be perfected under the PPSA.

6.2 Non-Application to Sales in Bulk

Under section 4(1)(g) of the PPSA, the PPSA does not apply “to a sale of accounts or chattel paper as part of a transaction to which the Bulk Sales Act applies.” The Bulk Sales Act R.S.O. 1990, c. B.14 applies with respect to a “sale of stock in bulk out of the usual course of business or trade of the seller”. Under the Bulk Sales Act, “stock” is defined as (i) goods, wares, merchandise or chattels ordinarily the subject of trade and commerce, (ii) the goods, wares or merchandise or chattels in which a person trades or that the person produces or that are the output of a business, or (iii) the fixtures, goods and chattels with which a person carries on a trade or business. “Stock in bulk” is defined as the “stock or part thereof that is the subject of a sale in bulk and all other property, real or personal, that together with stock is the subject of a sale in bulk.”

Thus, where leases are transferred to a purchaser in connection with the sale of the “stock in bulk” of a lessor, the PPSA will not apply to the transfer of such leases and the purchaser will not have to perfect its interest in such leases (the corollary is that the purchaser will have to comply with the requirements set out in the Bulk Sales Act regarding sales in bulk). However, if there is any ambiguity regarding whether a sale is a “sale in bulk” for the purposes of the Bulk Sales Act, the purchaser should register the associated assignment of leases under the PPSA.

6.3 Registration of Absolute Assignments of Leases

(i) Collateral Classification

When registering an absolute assignment of a lease, similar considerations apply as with registering a security interest in a lease, as discussed in Section 5.0 of this paper. Given that a lease comes within the definition of “chattel paper” under the PPSA, one should select the collateral classification “Other” when preparing the financing statement. The time period for the registration should be set to after the expiry of the term of the transferred lease, or if the assignment is of more than one lease, after the last expiry date of such lease terms. As discussed above, because the registration is in respect of a deemed security interest in chattel paper, pursuant to section 7(1) of the PPSA the registration should be made in the jurisdiction in which the assignor is located at the time at the time the security interest attaches, i.e. where the assignor was located at the time the assignment or purchase and sale agreement was executed.
(ii) Limiting the Scope of the Registration

As well, as discussed above, it is generally good practice to limit the scope of one’s security interest by providing a specific collateral description in the financing statement. When dealing with a large portfolio of leases, however, it is usually not feasible to list every lease which is being transferred and assigned. The following is an example of a specific collateral description used in connection with an absolute assignment of a lease portfolio:

Absolute assignment of leases and lease receivables pursuant to a Lease Portfolio Purchase Agreement dated as of [Date], between [Seller/Assignor of leases] and [Purchaser/Assignee of leases].

In this case, the specific collateral description must of necessity be sufficiently general to capture all of the leases in the class of leases being assigned, which may result in the scope of the security interest not being sufficiently limited to assuage the concerns of a subsequent secured lender. However, such a description may still be of use to a secured lender registering a pledge of shares or some other form of collateral which is not a lease but which is specified under the “Other” collateral classification in a financing statement.

6.4 Assignment of Existing Security Interests

As mentioned above, a sale of the underlying leased property almost invariably accompanies an absolute assignment of a lease. In this case, the assignee of the lease, who is also purchasing the underlying property, will want to obtain the benefit of any security interest registered by the assignor against the lessee of the property. Under section 21(2) of the PPSA “[a]n assignee of a security interest succeeds in so far as its perfection is concerned to the position of the assignor at the time of the assignment.” Thus, if the assignee/purchaser of the property obtains an assignment of the security interest of the assignor, it will essentially step into the shoes of the assignor vis-à-vis the lessee and enjoy whatever priority to the property then enjoyed by the assignor. Accordingly, the parties should register a financing change statement evidencing the assignment of the existing registration to the assignee pursuant to section 47(1) of the PPSA.

6.5 Best Practices

(a) The purchaser/assignee of the lease should ensure that a financing statement is filed in connection with the absolute assignment of such lease. If there is ambiguity as to whether the absolute assignment forms part of a “sale in bulk” under the Bulk Sales Act, it is better to err on the side of caution and register the assignment under the PPSA.

(b) The purchaser/assignee should ensure that the collateral classification “Other” is selected when registering a financing statement in connection with an absolute assignment of leases.
(c) The purchaser/assignee should ensure that, where it is not taking physical possession of the lease or leases being transferred, that the assignment is registered in the jurisdiction where the debtor is located for the purposes of section 7 of the PPSA. If there is some ambiguity as to where the debtor is located for the purposes of registering the security interest, then a financing statement should be registered in each of the jurisdictions in which the debtor is potentially located.

(d) The purchaser/assignee should ensure that a financing change statement is registered pursuant to section 47(1) of the PPSA to provide for the assignment of the security interest of the assignor registered against the lessee of the property subject to the assigned lease.

(e) Consider limiting the scope of the registration by including a specific collateral description.