

CASH IS KING - TAKING CONTROL OVER CASH COLLATERAL

Posted on January 18, 2022

Categories: [Insights](#), [Publications](#)

Introduction

Cash is used as a form of collateral in a wide variety of financial transactions as it is readily quantifiable and easily realized upon by secured creditors. In secured lending transactions, a debtor's cash may form part of the lender's general security or may be deposited with a financial institution to support certain contingent obligations (such as outstanding letters of credit). Cash collateral also plays a significant role in supporting certain over-the-counter ("OTC") derivative transactions. Indeed, proposed changes to the regulatory margin requirements for OTC derivative transactions are expected to make cash the more desirable form of collateral and, in certain cases, the only usable form of collateral for these transactions.

In light of the importance of cash collateral in financial transactions, lenders, OTC derivative transaction counterparties and other secured parties often seek certainty as to the validity and priority of their interest in cash collateral as against other third parties. From a secured party's perspective, perfection of its security interest by control provides it with the greatest certainty and strongest perfection. However, in contrast to Article 9 of the *Uniform Commercial Code* (the "**Article 9**"), personal property security legislation in the common-law provinces of Canada currently do not permit secured parties to perfect a security interest in cash by control.

Security in Cash under Article 9: Perfection by Control

Under Article 9, a security interest in a commercial deposit account^[1] may be perfected by "control." A secured party can obtain control in a deposit account under Article 9 in one of three ways. First, the secured party will automatically have control if it is the bank that maintains the deposit account in the debtor's name.^[2] Second, where the secured party is not the deposit bank, it can obtain control by entering into a control agreement with the debtor and the deposit bank.^[3] A control agreement is an agreement pursuant to which the deposit bank agrees to comply with the secured party's instructions regarding the disposition of funds in the deposit account without the debtor's further consent. Third, the secured party can obtain control by becoming the bank's customer with respect to the deposit account, thereby gaining the right to dispose of funds in the deposit account.^[4]

In the event of competition between multiple security interests in the same deposit account, the priority rules set out in section 9-327 of Article 9 apply, and a secured party perfected by control prevails over competing secured parties who do not have control.^[5] Where two secured parties have control of a deposit account, they rank according to priority in time of obtaining control – with first priority accorded to the secured party who obtained control the earliest^[6] – subject to the following two exceptions: (i) a security interest held by the bank that maintains the deposit account has priority over a conflicting security interest held by another secured party; and (ii) a security interest held by a secured party that becomes the bank’s customer with respect to the deposit account has priority over a security interest held by the bank with which the deposit account is maintained.

Security in Cash under the PPSA: Perfection by Registration

Under the Personal Property Security Act (Ontario) (the “**PPSA**”) and the equivalent personal property legislation in the other common-law provinces of Canada, deposit accounts are considered “accounts” that the depository financial institution owes to the depositing account holder. As such, deposit accounts generally fall within the scope of “intangibles” for the purpose of the PPSA. The PPSA does not provide a mechanism by which secured parties can perfect their security interest in intangibles by way of control. Instead, a secured party must perfect its security interest in intangibles (including against deposit accounts) by registration of a PPSA financing statement.

In the event of competition between multiple security interests that are perfected by registration, priority is determined by the order of registration.^[7] However, there are some exceptions to this general priority rule. For example, a secured party may take a purchase-money security interest (a “**PMSI**”) in any property that the secured party finances, sells or leases to the debtor, provided the requirements for a PMSI are met.^[8] A PMSI provides the secured party with a first-ranking security interest in the property that the secured party financed, supplied or leased, regardless of the order of perfection by registration. The PMSI and its priority status also extends to any cash or non-cash proceeds from the sale of such property. The consequence of this is that a secured party that has a first-priority security interest in a deposit account may lose its priority to the extent that cash deposited into such account constitutes a PMSI.

As a result, reliance on the perfection by registration regime for deposit accounts under the PPSA – in comparison to the perfection by control regime under Article 9 – results in less certainty for secured parties taking a security interest in cash. In order to mitigate some of this uncertainty, secured parties should conduct due diligence prior to taking a security interest, including conducting appropriate searches and obtaining relevant estoppel letters from any prior secured parties. However, under the PPSA, secured parties still cannot be assured that their security interest in deposit accounts will not be overridden by PMSIs or other exceptions to the general priority rules for perfection by registration.

Proposals for Amendments to the PPSA

In February 2012, the Ontario Bar Association (the “**OBA**”) submitted a proposal (the “**OBA Proposal**”) to the Government of Ontario, recommending amendments to the PPSA to establish a control regime for perfecting security interests in cash collateral. The stated purpose of these proposed amendments was “to facilitate the use of cash ... as collateral for loans and other secured obligations.”^[9] The OBA Proposal’s proposed amendments were largely modeled on the Article 9 control regime,^[10] and would permit perfection by control over a new category of collateral (“**financial accounts**”) that includes deposit accounts and any other monetary obligations of a financial institution in respect of funds held or received by that financial institution as security for an obligation. However, the Government of Ontario’s 2012 budget as passed ultimately did not include the amendments proposed by the OBA.^[11]

In line with the OBA Proposal, successive advisory councils created by the Ontario Ministry of Government and Consumer Services (the “**MGCS**”) have also recommended that the PPSA be amended to enable security interests in cash collateral to be perfected by control in order to provide greater assurance to secured parties with a first priority interest – first in the fall of 2016,^[12] and most recently in October 2019.^[13] However, various stakeholders and interested parties have raised some concerns with the proposed amendments. For example, some academics have highlighted the potential proliferation of “secret liens” in financial accounts if perfection by registration, which serves as a form of providing notice to the public, is not required.^[14] In addition, other stakeholders representing pension beneficiaries have advocated for the preservation of the super-priority security interest in accounts and inventory afforded to deemed trusts arising under employment and pension legislation pursuant to subsection 30(7) of the PPSA.^[15] Indeed, the OBA has stated that it does not support any change to subsection 30(7) of the PPSA which would subordinate the interests of workers and pensioners under employment and pension legislation to those of creditors with a perfected security interest in an account, inventory or a financial account.^[16]

As of today, the Ontario legislature still has yet to implement any of the aforementioned recommendations and amend the PPSA accordingly. By contrast, on April 21, 2015, the Government of Québec amended the *Civil Code of Québec* to facilitate the perfection of security interests in cash collateral by control in a manner similar to Article 9. Quebec is the only Canadian province or territory to adopt a perfection by control regime for cash collateral.

Practical Considerations in the Meantime

Secured parties need to understand and plan for the differences between the current PPSA rules and the rules of other jurisdictions that contain such a control regime. Secured parties taking a security interest in cash collateral should: (a) continue to register a PPSA financing statement against the debtor in the appropriate

PPSA jurisdiction; and (b) conduct PPSA searches against the debtor in such jurisdiction and negotiate with those secured parties with prior-perfected (and hence higher-ranking) security interests in the same cash collateral for subordination, waiver or estoppel agreements. As an additional step, secured parties should consider entering into a deposit account control agreement with the financial institution that maintains the cash collateral in Canada, even though such an agreement does not relate to perfection of a security interest in the common-law provinces of Canada.^[17]

Until the PPSA is amended to establish a control regime for cash collateral, lenders, derivatives counterparties and other secured parties will continue to face uncertainty as to their priority position when accepting cash collateral in the common-law provinces of Canada, which will continue to put such parties at a disadvantage when engaging in business in the common-law provinces of Canada.

This bulletin updates McMillan's December 2015 article titled [Canada: Getting It Perfect in Cross-Border Financings: Cash Collateral](#).

[1] UCC § 9-109(d)(13) excludes the application of Article 9 from “an assignment of a deposit account in a consumer transaction”, other than for § 9-315 and § 9-322 with respect to proceeds and priorities in proceeds.

[2] UCC § 9-104(a)(1).

[3] UCC § 9-104(a)(2).

[4] UCC § 9-104(a)(3).

[5] UCC § 9-327(1).

[6] UCC § 9-327(2).

[7] See PPSA, RSO 1990, c P10 s 30(1).

[8] See PPSA, s 33.

[9] Ontario Bar Association, Personal Property Security Law Subcommittee, “[Perfecting Security Interests in Cash Collateral](#)” (6 February 2012) at 3, online (pdf) [OBA Proposal].

[10] The OBA Proposal differs from the control regime in Article 9 in the two respects. First, control is the only method permitted under Article 9 for perfecting security interests in deposit accounts as original collateral, whereas the OBA Proposal would enable a secured party to perfect such security interest either by control or by registration; see the OBA Proposal, *supra* note 9 at 9. Second, the scope of the control regime in Article 9 is limited by the definition of “deposit account,” which excludes investment property and accounts evidenced by an instrument, as well as accounts maintained by any non-bank financial institution. In contrast, the OBA Proposal uses a different term, “financial account,” defined broadly to include not only deposit accounts but also monetary obligations of non-bank financial institutions related to any funds held by such financial institutions as security. As a result, control under the OBA Proposal is a method available for perfecting security interests in all cash collateral arrangements involving a financial institution; see the OBA Proposal, *supra* note 9

at 32.

[11] *Strong Action for Ontario Act (Budget Measures)*, 2012, SO 2012, c 8.

[12] Business Law Advisory Council, "[Report to Minister of Government and Consumer Services](#)" (3 February 2017), online (pdf).

[13] Ontario, Ministry of Government and Consumer Services, "[Business Law Modernization and Burden Reduction Council Recommendations to Modernize Ontario's Business Law Statutes](#)" (11 October 2019), online (pdf).

[14] See Ontario Bar Association, "[2019 Business Law Modernization and Burden Reduction Council's Recommendations to Modernize Ontario's Business Law Statutes](#)" (26 November 2019) at 11-12, online (pdf) [OBA Report].

[15] See PPSA, s 30(7).

[16] OBA Report, *supra* note 14 at 8-9.

[17] For more information, please see the bulletin "[Blocked Account Agreements in Canada – Back to Basics](#)" (26 August 2021), online: *McMillan LLP*.

by [Alex Ricchetti](#) and [Maria Sagan](#)

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.

© McMillan LLP 2022