

PERSONAL PROPERTY SECURITY ACT (ONTARIO) AMENDMENTS

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On December 20, 2006, S.O. 2006, c.34, entitled "An Act to modernize various Acts administered by or affecting the Ministry of Government Services" (formerly Bill 152) (the "**Act**") received royal assent. Schedule E to the Act contains amendments to the *Personal Property Security Act* (Ontario) (the "**PPSA**"), most of which are scheduled to be proclaimed into force on August 1, 2007 (only sections 3(2), 5 and 6 of Schedule E to the Act (the "location of debtor" change to the conflicts rules and the transitional provisions relating to that change) remain "unproclaimed"). As the name suggests, the Act is part of the Ontario government's continuing efforts to update and modernize business law in Ontario; more than thirty Ontario statutes are amended by the Act, some more extensively than others.

The PPSA is one of the statutes substantially amended by the Act. The purpose of this memo is to highlight some of the key changes made to the PPSA by the Act. A number of the amendments are more technical in nature and I will not deal with them in this article; instead, I will focus on those changes which have more practical, everyday significance for business lawyers in Ontario and their clients.

Definition of "Debtor"

The Act expands the definition of "debtor" to include a person who "owns or has rights in the collateral, including a transferee of or a successor to a debtor's interest in collateral". Of significance, the new definition expressly contemplates that the person who owes payment or other performance of the obligations secured may be different than the person owning or having rights in the collateral.

From a practical perspective, this will obviate the need to obtain a guarantee from a person owning collateral where the sole reason for such guarantee is to enable the secured party to obtain a valid security interest in such collateral. As an example, when a shareholder of a borrower is required to pledge shares as security for a loan to the borrower but is not otherwise required to guarantee the indebtedness, the shareholder is often required to provide a "limited recourse guarantee" to create an obligation that can be secured by the share pledge. With the extension of the definition of debtor contained in the Act, such shareholder will simply be able to grant a pledge without having to give a limited recourse guarantee.

Leases for a Term of More Than One Year

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Another important change to the PPSA made in the Act is that the PPSA will apply to leases for a term of more than one year. The PPSA will apply to such leases "even though the lease may not secure payment or performance of an obligation".

The issue of whether a lease is a "true lease" or a "financing lease" has been the subject of considerable litigation over the years. Since all leases (regardless of type) with a term of more than one year will be subject to the PPSA, lessors (or their counsel) will be required to file financing statements and otherwise comply with the provisions of the PPSA in respect of such leases. Counsel will no longer have to analyze factors such as the identity of the lessor, the value of any purchase options and intention of the parties in determining whether registration of a financing statement is necessary to protect the lessor's interest.

It is important to note that the term "lease for a term of more than one year" includes, in certain circumstances, leases for one year or less. For example, if a lease provides that it is renewable for one or more terms at the option of one of the parties or by agreement of all of the parties and therefore could extend beyond one year, it will be deemed to be a lease for a term of more than one year for purposes of the PPSA.

Despite this amendment, however, the Act adds new section 57.1 to the PPSA, which provides that the rights and remedies on default, as set out in part 5 of the PPSA, only apply to leases that secure payment or performance of an obligation. Therefore, where there is a "true lease", the rights and remedies of the parties after default will continue to be determined outside the PPSA.

Location of Debtor

Another issue under the PPSA which often requires significant analysis relates to the conflicts of laws provisions, and specifically the determination of where a debtor is located. Section 7 of the PPSA deals with the validity of security interests in certain types of collateral, primarily security interests in intangibles and non-possessory security interests in instruments, negotiable documents of title, money and chattel paper. That section provides that the law of the jurisdiction where the "debtor is located" governs such issues. Currently, to establish where a debtor is located, a secured party has to determine the location of the debtor's place of business or, if there is more than one place of business, the location of its chief executive office; only by determining this can a secured party know which law governed these issues. Typically a secured party will have to rely on a certificate from an officer of the debtor to get this information since it is not something that can be conclusively determined by searches of public records.

As a result of the changes to Section 7 of the PPSA contained in the Act, if a debtor is incorporated, continued, amalgamated or otherwise organized under the laws of a province or territory of Canada, it will be deemed to be located, for the purposes of section 7 of the PPSA, in such province or territory. Companies incorporated under Canadian federal law will be deemed to be located in the jurisdiction in which the registered or head

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office is located, as set out in its articles or letters patent. If the debtor is an organization registered under the laws of a U.S. state, the laws of such state will govern the issues in Section 7 of the PPSA. If the debtor is a partnership, other than a limited partnership, and the partnership agreement contains a governing law clause, the laws of the jurisdiction set out in such clause will govern. And for individuals, the location of the individual's principal residence will dictate the law which governs.

There are other specific rules which relate to certain additional types of entities, but the good news for secured parties and practitioners is that for most corporations, limited partnerships and other registered organizations, it will be possible to do searches of public records to determine the appropriate governing law for the purposes of section 7 of the PPSA.

The Act also provides transition rules relating to the amended provisions of Section 7 of the PPSA to ensure that secured parties have sufficient time to determine the proper law governing the validity, perfection and effect of perfection and non-perfection and the priority of security interests contemplated by section 7 of the PPSA and to take such steps as may be necessary to ensure continuous perfection of such security interests. The rules are somewhat convoluted, but generally speaking, secured parties will have five years from the date on which the Act comes into force to make any necessary registrations to maintain perfection of their security interests under the new conflicts of laws rules in Section 7.

As mentioned above, the conflicts of laws provisions and the related transitional rules have not yet been proclaimed into force; this is to allow time for the other provinces in Canada to pass similar amendments in order to provide consistency throughout Canada.[1]

Transactions in the Ordinary Course of Business

Section 28 of the PPSA sets out various provisions to protect a buyer of goods who purchases from a seller who sells the goods in the ordinary course of business. Such a buyer receives the goods free of any security interest granted by the seller, even a perfected security interest of which the buyer is aware. The Act will add to this protection by providing that it applies whether or not (i) the buyer takes possession of the goods, (ii) the seller was in possession of the goods at any time, (iii) title to the goods passed to the buyer, or (iv) the seller took a security interest in the goods. These changes are reflective of the Ontario government's policy of protecting consumers over secured parties.

Inventory PMSIs

The Act makes a significant change to the provisions and procedures relating to purchase-money security interests ("**PMSI**") in inventory. One of the sources of conflict under the existing PMSI rules is between inventory financiers and receivables financiers. Since a secured party which follows the rules relating to

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inventory PMSIs gets a priority in respect of such inventory, <u>and the proceeds thereof</u>, a secured party which finances the accounts receivable of such debtor could lose its priority with respect to accounts receivable purchased or financed by it; more troubling, this could happen without its knowledge. Since the inventory financier is only required to send a PMSI notice to prior secured creditors who have checked the "inventory" box on the financing statement, receivables financiers are not necessarily notified of the PMSI being claimed in the inventory and its proceeds (including the receivables arising from the sale of such inventory).

Under the Act, a secured party seeking to obtain a PMSI with respect to inventory will be required to give notice to all secured creditors with a prior registered security interest in inventory and accounts. This will be a fundamental change in the manner in which inventory financiers protect their interests.

Service of Notices

As another illustration of the Act's modernization of business law, Section 68 of the PPSA will be amended to update the means by which notices and documents may be sent, and will include the sending of notices by fax or electronic transmission (in addition to personal service, prepaid courier and registered mail). Section 68 will also be amended to provide for the deeming of receipt of notices; of significance is the fact that the amendments will deem inventory PMSI notices to be delivered upon expiry of a 10 day period following registration of registered mail, if delivered in that fashion, or upon actual receipt or the first business day after, whichever is earlier, of transmission by fax or electronic transmission. This amendment will create certainty for inventory financiers as to when the priority of the PMSIs will commence.

Registrations

As mentioned above, there are a number of additional changes to the PPSA in the Act, including the fact that registration will no longer be permitted in paper form; only electronic registrations will be accepted. Furthermore, the commentary from the government that accompanies the Act indicates that the system for registration in Ontario of "checking the boxes" on a financing statement will be replaced with a system requiring the secured party to describe the collateral in which it has a security interest (as is the case will all other provinces and territories in Canada). The timing for this change is not yet known and depends, in large part, on the government ensuring that its computer system is able to handle this change.

Next Steps

We will provide an update as to the timing of proclamation of those sections of Schedule E to the Act which have not yet been proclaimed. In the meantime, if you have any questions on any of the changes described above or on any other aspect of the Act as it relates to the PPSA, please do not hesitate to contact me or any other member of the Banking and Project Finance Practice Group.



[1] It is worth noting that the *Securities Transfer Act, 2006* (Ontario), which was proclaimed into force on January 1, 2007, included certain amendments to the PPSA relating to, among other things, conflicts of laws provisions regarding the validity of security interests in "investment property". However, the Act does contain various transition rules regarding the determination of law governing the validity, the perfection, the effect of perfection or of non-perfection and the priority of all security interest in investment property.