BLOCKED ACCOUNT AGREEMENTS IN CANADA - BACK TO BASICS

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Cash is often an integral part of a lender's collateral in secured lending transactions. However, the liquid nature of cash poses certain challenges on lenders seeking to rely on cash as collateral. A blocked account agreement ("**BAA**") is a useful tool for lenders for cash management and aids in the enforcement of their security interest against cash in deposit accounts. In this bulletin, we provide a general overview of the nature and function of BAAs in the context of secured lending transactions in the common-law provinces of Canada.

What is a blocked accounts agreement?

A BAA is a tripartite agreement between a lender, a borrower and a third party bank maintaining a deposit or collection account of the borrower (the "**Subject Account**"). The purpose of a BAA is to transfer authority to provide instructions regarding the Subject Account from the borrower to the lender. As a result, the borrower is "blocked" from accessing or transferring funds held in the Subject Account and the lender will have exclusive authority to instruct the account bank with respect to the Subject Account. The lender's instructions may include withdrawals and transfers, directing sweeps into another account, or making changes to the account, such as, changing the name of the account, the account number or the ownership.

When is a BAA used?

A BAA is commonly used in asset-based lending transactions where the borrower's accounts are maintained with a third party bank. In an asset-based lending transaction, the accounts receivable of the borrower are a fundamental part of the lender's security package. The lender will often require a BAA in respect of the borrower's collection accounts to ensure it has the ability to control payments and transfers out of such accounts. In asset-based lending transactions, a BAA is likely part of a larger cash management system, which may also include lockboxes, cash sweeping arrangements and consolidation accounts.

A BAA is also frequently used in project financing transactions where the borrower's accounts are maintained with a third party bank. In a project financing transaction, the revenue generated from the project is the primary means by which the lender's loan is repaid. As a result, the lender will often require a BAA to obtain control over the project revenue received by the borrower to ensure that the project revenue is disbursed according to the loan documents to pay project costs and repay the loan. Depending on the nature of the project, the borrower may also be required to maintain certain reserve accounts for the project and the lender may also require a BAA in respect of these reserve accounts.

What are the types of BAA?

There are two types of BAAs – a general BAA and springing BAA. The difference between a general BAA and a springing BAA is the time at which the authority to provide instructions regarding the Subject Account is transferred from the borrower to the lender. In a general BAA, the authority to provide instructions is transferred to the lender at the onset of the credit facility. As a result, the borrower is immediately restricted from accessing or transferring funds held in the Subject Account. In a springing BAA, the authority to provide instructions is transferred to the lender only after some trigger event. The trigger event is the delivery of an activation notice by the lender to the account bank, which likely can only be delivered if the borrower is in default. Until the occurrence of the trigger event, the borrower maintains its authority to access and transfer funds in the Subject Account.

What is the US equivalent of a BAA?

In the United States ("**U.S**."), lenders use a document similar to a BAA that is referred to as a Deposit Account Control Agreement ("**DACA**"). A DACA functions in a similar manner to a BAA in that it transfers authority to provide instructions in the Subject Account to a lender. Both the DACA and BAA are used by lenders as part of a cash management system with respect to borrowers and as a tool for enforcement in a default scenario. However, a DACA serves an additional purpose in the U.S.

In the U.S., the *Uniform Commercial Code* (the "**UCC**") permits lenders to perfect a security interest in deposit accounts by control. A security interest in deposit accounts that is perfected by control has an enhanced priority position and will prevail against other secured interests that are not perfected by control. A DACA is one method by which a lender can obtain perfection by control against deposit accounts under the UCC.[1] In contrast, the *Personal Property Security Act* (Ontario) (the "**PPSA**") and the equivalent personal property legislation in the other common-law provinces and territories of Canada do not permit a lender to perfect a security interest in deposit accounts by way of control. Instead, a lender must perfect a security interest in deposit accounts by registration of a PPSA financing statement, and is subject to the usual priority rules for PPSA filings. As a result, unlike a DACA, a BAA does not perfect a security interest in deposit accounts.

The perfection by control function of a DACA makes it an attractive tool for lenders in secured lending transactions in the U.S. Whether a lender's security interest is governed by the UCC or the PPSA will determine whether the use of a DACA or a BAA is appropriate.

What are the frequently negotiated provisions in a BAA?

Each major bank in Canada has its own standard form of BAA. Account banks generally prefer to use their own forms to ensure that all blocked accounts are consistently managed. However, there are several key provisions that a lender may wish to negotiate before signing a BAA, including the following[2]:

Indemnities – A BAA often requires an indemnity from the borrower and the lender in favour of the account bank. From the lender's perspective, the scope of its indemnity to the account bank should be limited to the extent possible. In practice, the indemnity is frequently limited to those liabilities of the account bank incurred after the authority to provide instructions has been transferred to the lender.

Termination Rights - A BAA often permits the account bank to terminate the BAA upon prior written notice to the lender. The lender should consider whether the notice period provides sufficient time to allow the lender and the borrower to make alternate arrangements that ensure the lender remains in control of the Subject Accounts. The alternative arrangements may involve moving the borrower's account(s) to a new account bank and entering into a new BAA.

Fees and Chargebacks – A BAA often permits the account bank to debit the Subject Account for any fees and chargeback amounts associated with such account. If there are insufficient funds in the Subject Account for such fees and chargeback amounts, the account bank is usually entitled to payment of such amounts from the borrower or lender. From the lender's perspective, the scope of its liability for fees and chargeback amounts should be limited to the extent possible. In practice, the lender's liability for such amounts is often limited to the aggregate amount transferred from the Subject Account to the lender pursuant to the BAA or the lender's instruction.

Conclusion

In the common-law provinces of Canada, the BAA remains an important tool for lenders relying on cash collateral in secured lending transactions. It is important for lenders to understand the purpose and function of BAAs to ensure they are used in appropriate circumstances to reduce risk and manage cash collateral effectively.

[1] UCC § 9-104(a)(2).
[2] "Blocked Account Agreement (Account Bank Not Party to Loan Transaction)", *Practical Law Canada Finance*.

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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.