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April 28, 2006

**DELIVERED**

The Honourable Gerry Phillips
Minister of Government Services
99 Wellesley Street West
Room 4320, Whitney Block
Toronto, Ontario
M7A 1A1

Dear Mr. Minister:

**Re: PPSA Reform - April Submission**

I am writing in my capacity as co-chair of the Personal Property Security Law subcommittee of the Business Law section of the Ontario Bar Association. This letter contains our additional recommendations for PPSA reform, as promised in my February 13, 2006 letter to you.

Our subcommittee has four additional recommendations for PPSA reform, as follows:

1. Out of step with all other PPSAs in Canada, the Ontario PPSA requires a secured party to check up to five boxes to classify its collateral, without providing any further description of the collateral. The Ontario rules frequently delay transactions and increase borrowing costs, without providing benefits to anyone by doing so. We recommend that the Ontario PPSA be modernized to conform with the other PPSAs and the approach taken under Article 9 of the UCC in the United States, by requiring a secured party to describe its collateral by "item or type". This change will reduce the cost of secured transactions in Ontario -- a cost paid by Ontario borrowers.

2. Under rules which differ from the rest of the PPSAs in Canada and Article 9 of the UCC in the United States, the Ontario PPSA does not adequately address a priority contest between an accounts receivable financer and an inventory financer. We recommend that the Ontario PPSA be conformed with the PPSAs in the Atlantic provinces to require that an inventory financer give notice to an accounts receivable financer if the inventory financer intends to rely on the special "purchase-money security interest" priority rules. This change will make the Ontario rules fairer.

3. The process for PPSA reform in Ontario is haphazard, and does not encourage stakeholders to participate. We recommend that the Ontario PPSA provide for the creation of a permanent advisory committee to work with Ministry staff to modernize the Ontario PPSA, and to keep it modern. This change is consistent with the Ministry's goal to modernize Ontario business laws.

4. All PPSAs in Canada contain conflict of laws rules which define the location of a business debtor by reference to its chief executive office. In practice, this often creates confusion about the proper jurisdiction for registrations and searches. We recommend that the Ontario PPSA (together with all other PPSAs) be amended to conform generally with the approach in Quebec and the United States, by defining the location of a business debtor by its jurisdiction of incorporation or organization. This change will reduce the cost of secured transactions in Ontario -- a cost paid by Ontario borrowers.

Details about each of the first three recommendations are set forth in Schedules "A", "B" and "C", each of which sets forth the names of the primary authors of those recommendations. We are still working on the fourth recommendation, hoping to provide our draft PPSA amendments to you shortly. Schedule "D" lists the names of the current members of our PPSL subcommittee.

We confirm that our subcommittee continues to support the recommendations for reform from the 1998 submission as described in my February 13, 2006 letter to you.

Mr. Allen Doppelt (Senior Counsel) and Mr. Eliezer Brodt (Senior Policy Analyst) of your Ministry have observed our process to prepare these recommendations, and are anticipating this submission. We thank your Ministry for supporting Mr. Doppelt and Mr. Brodt to participate in our numerous meetings and conference calls. We look forward to continuing our work with your Ministry on these and other important areas of PPSA reform.

Yours truly,

R. John Cameron

R. John Cameron

RJC

cc: Mr. Allen Doppelt
Mr. Michael Burke, co-chair
Members of the PPSL Subcommittee
Members of the Executive of the Business Law Section

# Schedule "A"

## Eliminating "Check-Box" Collateral Classification

**Proposal: Ontario should eliminate the current "check-box" collateral classification system for registrations in favour of an "item or type" description system.**

The proposal for reform.

Ontario has a system for describing collateral on a financing statement which requires that the party completing the statement set out "the classification of the collateral as consumer goods, inventory, equipment, accounts or that the classification is other than consumer goods, inventory, equipment or accounts or any combination thereof".[1] This translates into a series of boxes on the financing statement which are to be checked or left unchecked to indicate that the secured party's collateral claim falls or does not fall within those classifications.

Our proposal is that this system be replaced with one that requires the secured party to describe its collateral claim by the specific items or types of collateral – that is, a narrative description rather than a series of check-boxes.

We have attached as an appendix to this proposal our specific recommendations for amendments to the Act and to the general regulation made under the Act to implement the elimination of the check-box system. However, the most significant changes required may well be to the Ministry's computerized registry systems, and we do not pretend to have sufficient expertise in that regard to provide specific recommendations. We do note, as discussed below, that all other PPSA and UCC Article 9 registry systems accommodate "item or type" descriptions, so the technical issues should not be insurmountable.

The rationale for the proposal.

*Harmonization*. Every jurisdiction in Canada and the U.S., without exception, now has a personal property security registry of some kind. Ontario's is the only one using the "check-box" system. This carries the potential to confuse users of the system in both directions. Parties from other jurisdictions may use their collateral descriptions from those jurisdictions in the Ontario registry, with or without checking any boxes, and with no apparent knowledge that the systems are different. Users familiar with the Ontario system may attempt to replicate its "check-box" feature when registering in other jurisdictions, with results which may not be easily predictable (*e.g.*, an Alberta

[1] General Regulation under the PPSA, R.R.O. 1990, Reg. 912 as am., s.3(1)(f).

registration whose collateral description reads "inventory, equipment, accounts and other"). Now that personal property security registry systems are ubiquitous, we believe that the Ontario system is increasingly viewed as an anomaly and a curiosity.

*The Ontario system is an historical and technological anomaly.* Our understanding is that the reason for the present Ontario system dates to its early use of computer technology. When it was originally decided to enact legislation based on the Article 9 model but including a computerized registry, data storage space was considerably more expensive per unit of storage than it now is. The state UCC systems then used (and some still use) physical filing of financing statements or index-card abstracts; when the decision was made to computerize in Ontario each piece of information on the financing statement was required to fit into a field with a specified number of characters.[2] When it came time to consider the collateral description field, the "check-box" system enabled the "general collateral description" area on the financing statement to be made both optional[3] and arbitrarily small, minimizing the data storage requirements. An "X" in the box for equipment, for example, enabled the secured party to perfect a security interest in the debtor's present and after-acquired property within the "equipment" classification, and its proceeds, with one character. In 1976, this was a significant saving.

However, it is not 1976 any more, the cost of data storage is considerably lower, and we believe that this system's continued use should be reconsidered given the other factors identified here.

*There are real transactional costs to the current system.* There are a number of actual or apparent uncertainties in the current system that impose real costs on the completion of transactions in Ontario that are not present elsewhere. It is not always easy to discern what a secured party actually "meant" by a registration, leading subsequent secured parties, buyers of assets from the debtor, and third parties such as auction houses to assume the worst and approach prior secured parties for waivers of interest, subordinations or partial discharges which may not have been necessary had those prior parties been required to describe their collateral claims in a narrative fashion. Every participant in the equipment finance industry, for example, maintains at least one employee whose job it is to answer these requests. Ontario has already taken some steps to address this problem (*e.g.* ss.51(2.1)-(2.4) of the PPSA dealing with wrongly claimed classifications or unlimited claims to a classification) but these are band-aid solutions at best. The root of the problem is the anomalous classification system itself.[4]

[2] This can be seen by the continuing and arbitrary restrictions on numbers of characters in first given names and surnames of debtors who are natural persons (19 and 22 characters respectively) in ss.16(2) and (3) of the General Regulation under the PPSA, *supra* note 1.

[3] See General Regulation under the PPSA, *supra* note 1, s.3(11); the optional nature of the collateral description was also mentioned in this Committee's submission to the then Minister respecting amendments to the PPSA: 1998 Submission, Recommendation 17 (page 23).

[4] Recommendations 17 and 18 from the 1998 Submission (pages 23-28), *supra* note 3, address some of the uncertainties and difficulties arising from the current system, but without suggesting that it be replaced.

*There are no good arguments to maintain the current system other than inertia.* We are not aware that anyone makes a principled argument for maintenance of the present system. It may be argued that it is easier for secured parties, which is true, but we would suggest that even the benefit to secured parties is offset by the additional costs later in the life of the registration. For example, it is certainly easier to check the "equipment" box than to attempt to provide an item or type description of collateral in some complex cases; but (i) a description of the collateral sufficient to identify it is already required in the security agreement[5], so the secured party is not relieved of the burden of coming up with one anyway, (ii) the secured party will certainly face demands for clarification or limitation (possibly, but not necessarily, under ss.51(2.1)-(2.4)) during the term of the registration in any event, and (iii) the secured party will not be able to avoid the description issue in any jurisdiction other than Ontario if the transaction involves more than one jurisdiction. We do not think that changing the description requirements will impose significant additional burdens on secured parties, in short.

Further research and consultation requirements.

To implement the change to the collateral description requirements we propose, it is necessary to exhaustively review the Act[6] and current General Regulation to determine what changes would be required. As well, there need to be transitional provisions enacted to deal with the effect of registrations made under the old system. Our efforts in this regard are attached as an appendix to this proposal, for the consideration of the Committee and, if accepted by the Committee, of the Ministry's staff and legislative counsel.

[5] PPSA, s.11(2)(a), assuming the secured party does not take possession of the collateral (and wishes its security interest to attach to the collateral!).

[6] Note that while the *Repair and Storage Liens Act* (R.S.O. 1990, c.R.25, the "RSLA") also uses the registry established under the PPSA, the present proposal would not seem to require any change to its registration system. There is no use of the present check-boxes, other than the indication that a motor vehicle is included – unless the item to which the repair or storage lien applies is a motor vehicle, the item is required to be described in the "general collateral description" area of the PPSA financing statement form and not by use of the boxes. (If it is a motor vehicle, then the particular vehicle is required to be described by vehicle identification number, which feature of the registry this proposal does not address.) See s.3(7) of the General Regulation made under the RSLA, R.R.O. 1990, Reg. 1003, as am. (and also, for example, s.7(5) relating to releases from lien of items other than motor vehicles).

Very significantly, the Ministry will also need to determine the system changes that would be made necessary by this change. At a minimum, the financing statement form (or data definition) would need to be changed in the Ministry's systems, and likely the current "general collateral description" area would have to be expanded.[7] There is certain to be a cost attributable to the changes, but assuming it is not outlandish we would submit that the cost is worth incurring as opposed to maintaining the current situation.

In addition to the proposal made here, there are a number of other possibilities that exist for modernization of the personal property security registry, one of the most significant of which would be the elimination of the option to file financing statements and financing change statements in paper forms in favour of a purely electronic registry system. Our committee would welcome the opportunity for further dialogue with the Ministry in relation to the prospects for changes of this kind.

David L. Denomme

Warren N. Barnard

Neil C. Saxe

Paul D. Wickens

[7] Note carefully that we do not propose, at this time, any changes which affect the manner of description of motor vehicles, or the specific requirements for registrations relating to consumer goods (other than elimination of the check-box actually labelled "Consumer Goods"). If a registration relates to consumer goods, the same requirements as presently apply to the registration will continue to apply, although there will be nothing to indicate that the registration is a "consumer goods registration". (For example, these registrations are limited to a five-year registration period while other registrations are not: see s.3(4) of the Regulation, *supra* note 1.) While there are particular requirements for consumer goods registrations in other jurisdictions, there is no other jurisdiction that labels the registrations as such, so this simply brings Ontario into line in this regard.

## Appendix: Specific changes to the present Ontario PPSA to implement the proposal.

Parts I-II

No changes necessary.

Part III

*Section 33*

Clause 33(1)(b) is amended to read as follows:

> (b) before the debtor receives possession of the inventory, the purchase-money secured party gives notice in writing to every other secured party who has, before the date of registration by the purchase-money secured party, registered a financing statement containing a description that (i) includes the same item or kind of collateral, (ii) describes the collateral as "inventory", or (iii) includes accounts.

Note: the underlined phrase replaces the words "in which the collateral is classified as inventory". For stylistic reasons, the order of the wording has also been changed, moving the phrase "*before the date of registration by the purchase-money secured party*" from the end of the subsection, where it currently appears.

Since financing statements would no longer classify collateral, the determination of whether collateral secured by a pre-existing financing statement is "inventory" will be based on the description of the collateral in the pre-existing financing statement. The suggested wording of the amendment is based on the wording of the Atlantic provinces' PPSAs, with an addition made to clarify that if the collateral is described as "inventory" alone (for example, in a financing statement filed prior to the elimination of the check-box system), a notice must be sent.

Where a financing statement provides no description of collateral, or where there is doubt as to the type of security held by a pre-existing security interest, the purchase-money secured party would be well-advised to send the notice.

Note carefully that this proposed amendment reflects another, different change to the PPSA recommended by our committee, being the suggestion that Ontario should adopt the Atlantic provinces' approach to the issue of priority over "accounts" between (i) the interest of a financer of those accounts as original collateral and (ii) the interest of a financer of inventory in the same accounts as proceeds. As described in connection with that proposal, the Atlantic approach provides priority for the inventory financer in this case, but only if the inventory financer has notified prior registrants against accounts, as well as inventory, of its PMSI.

Part IV

*Section 46*

Subsection 46(3) is deleted.

Note: presently this subsection reads as follows:

> 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.

This provision is only necessary because of the possibility that a collateral classification is claimed by use of the check-boxes but then limited by the use of words in the general collateral description area. When only a description is used, the claim is made in accordance with the description only, whatever it says, and there is no further need for this provision.]

*Section 51*

Subsection 51(5) is amended by replacing the words "a financing statement that indicates that the collateral is or includes consumer goods" by the words "if the collateral to which a financing statement relates is or includes consumer goods, such financing statement".

Note: this subsection restricts financing statements relating to consumer goods to registration periods of five years or less.[8] The amendment is made necessary because in the absence of the check-boxes the financing statement no longer "indicates" whether the collateral includes consumer goods. This change accords with existing provisions such as s.45(3), which provides that a financing statement may be registered before or after the security agreement is signed by the debtor "except where the collateral is consumer goods" – it is whether or not the collateral is consumer goods, not how it is indicated on the financing statement, that is relevant. The effect of the change from a registry perspective, however, is that the registry could not warn a registrant who attempted to register a financing statement relating to consumer goods for more than five years that its registration period would be limited to five years by operation of the Act, as the registry presently does. This is simply because the financing statement related to consumer goods would look identical to a financing statement not related to consumer goods, if the same goods and same debtor were involved but the use of the collateral is different.]

*Section 56*

Subsection 56(1) is replaced by the following:

> Where a financing statement or notice of security interest is registered under this Act, and,
>
> (a) all the obligations under a security agreement to which it relates have been performed;
>
> (b) it is agreed to release part of the collateral covered by a security agreement to which it relates upon payment or performance of certain of the obligations under the security agreement, then upon payment or performance of such obligations; or
>
> (c) the collateral description in the financing statement includes an item or kind of property that is not collateral under a security agreement between the secured party and the debtor,
>
> any person having an interest in the collateral covered by the security agreement may deliver a written notice to the secured party demanding a financing change statement referred to in section 55 or a certificate of discharge or partial discharge referred to in subsection 54 (4), or both, and the secured party shall sign and give to the person demanding it, at the place set out in the notice,

[8] Ontario is the only province with such a restriction in its PPSA, and it has been argued that the mandatory obligation imposed on a secured party to discharge registrations against consumer debtors after performance or other termination of their secured obligations is sufficient protection for consumers even without any restriction on the registration period: Cuming, Walsh and Wood, Personal Property Security Law (Toronto: Irwin Law, 2005), pp.259-60.

the financing change statement or the certificate of discharge or partial discharge, or both, as the case may be.

Subsections 56(2.1), (2.2), (2.3) and (2.4) are deleted.

In subsection 56(4), the reference to "subsection (1), (2), (2.1) or (2.2)" is replaced by a reference to "subsection (1) or (2)".

Note: This adds clause (c) to s.56(1), to deal with collateral claims that exceed the scope of a security agreement. It deletes subsections 56(2.1) – (2.4), which were all added to the PPSA recently and were intended to address problems that arose specifically from the check-box system itself. They allowed debtors to require registrants to "un-check" collateral classifications that were checked even though secured parties had no security interest in any collateral within that classification, and allowed debtors to require a limiting description (or at least a reference to a security agreement) where a classification was checked without any such limitation. Neither of these is necessary where there is no check-box, but rather an "item or kind" description only.

Compare this section to s.50 of the Alberta PPSA. Ontario s.56(1) is similar to Alberta s.50(3), but no attempt is made here to adopt the much more extensive procedures the Alberta (and some of the other non-Ontario PPSAs) have in connection to the issue of "overreaching" in collateral claims. An Ontario debtor (or other person having an interest in collateral covered by the security agreement) who is dissatisfied with the registrant's collateral claim may only notify the registrant to deliver a financing change statement designated as a full or partial discharge, and if the same is not provided "without reasonable excuse", the provisions of existing s.56(4) will apply. By contrast, in Alberta, the person giving the demand may itself register a financing change statement on notice to the registrar of its unfulfilled demand to the registrant.[9] Such a change is possible in Ontario but outside the scope of this proposal.

Part V - VI

No changes necessary.

Part VII

The following section is added following Section 83:

**Mandatory Collateral Description**

**84**(1) In this section "mandatory collateral description date" means **[●]**.

(2) A financing statement prepared and registered in accordance with the regulations prior to the mandatory collateral description date is not invalid by reason only of the fact that it does not comply with the regulations following the mandatory collateral description date.

(3) A financing change statement registered after the mandatory collateral description date concerning a change in collateral related to a financing statement described in

[9] See s.50(5) of the Alberta PPSA, R.S.A. 2000, c.P-7.

subsection (2) must comply with the regulations following the mandatory collateral description date.

(4) A financing statement in respect of a security interest created

(a) prior to the mandatory collateral description date and not perfected by a financing statement registered prior to the mandatory collateral description date; and

(b) after the mandatory collateral description date

must comply with the regulations following the mandatory collateral description date.

Regulation[10]

*Section 3*

Clause 3(1)(f) is deleted.

Subsection 3(11) is deleted and replaced by the following:

> Collateral other than (i) a motor vehicle that is classified as consumer goods or (ii) a motor vehicle that is classified as equipment or inventory but is described in accordance with subsection 3(8), must be described in accordance with section 18.1.

Subsection 3(13) is deleted.

Note: Clause 3(1)(f) is deleted because it mandates the use of the "check-boxes". Present s.3(11) allows but does not require the use of the general collateral description area where the collateral is not required to be described by vehicle identification number; this is replaced by a provision that requires a collateral description in accordance with new s.18.1 (below) except where the collateral is actually described by vehicle identification number – *i.e.* (i) where it is a motor vehicle and consumer goods (in which case the use of the number is mandatory by s.3(7)) or (ii) where it is a motor vehicle but is not consumer goods and is actually described by number (as is permitted by s.3(8)). In summary, all collateral that does not appear on a motor vehicle description line must now be described in the general collateral description area in accordance with new s.18.1.

The deletion of s.3(13) is incidental to the deletion of the check-boxes.

*Section 7*

In subsection 7(6), the words "the collateral may be described on line 13, 14 or 15 of the financing change statement" are deleted and replaced by the words "the collateral must be described in accordance with section 18.1".

[10] Amendments shown are to R.R.O. 1990, Reg. 912, as am. to O.Reg. 637/98. Pursuant to the *Red Tape Reduction Act, 1998* many of the matters which were formerly required to be dealt with by regulation may now be the subject of Ministerial orders under s.73.1 of the Regulation, including the forms used under the PPSA and the content of financing statements and financing statements (see ss.73.1(1)(e) and (f)). It would seem that the proper mechanism would be for a Ministerial order to issue and for the conflicting portions of the Regulation to be revoked: see S.O. 1998, c.18, Sched. E, ss.201(2)-(3). For convenience, the changes to the Regulation we believe to be necessary as a result of this initiative are set out here as amendments to the Regulation, and the precise form of later changes left to legislative counsel.

Note: this provision relates to assignments of security interest in part of the collateral to which a registration relates. It originally provided for optional description of collateral which is not either mandatorily described by vehicle identification number or optionally and actually described by that number. Because of the deletion of the check-box system, it is now required to provide an "item or type" description of the collateral to which the assignment relates in this circumstance.

*Section 8*

In subsection 8(6), the words "the collateral may be described on line 13, 14 or 15 of the financing change statement" are deleted and replaced by the words "the collateral must be described in accordance with section 18.1".

Note: this is the same situation as discussed with respect to s.7, but in connection with a transfer by the debtor of part of the collateral to which a financing statement originally related. The amendment and rationale are the same.

*Section 11*

In subsection 11(6), the words "may be described on line 13, 14 or 15 of the financing change statement" are deleted and replaced by the words "must be described in accordance with section 18.1".

Note: this is the same situation as discussed with respect to ss.6 and 7 above, but in connection with registration of a discharge with respect to part of the collateral to which a financing statement originally related.

*Section 18.1 (new)*

A new section is added following s.18 as follows:

> 18.1 (1) Where collateral is to be described under this section, the secured party must set out the description on lines 13, 14 or 15 of the financing statement and must provide
>
> > (a) a description of the collateral by item or kind or as "goods", "chattel paper", "securities", "documents of title", "instruments", "money" or "intangibles",
> >
> > (b) a statement indicating that a security interest is taken in all of the debtor's present and after-acquired personal property,
> >
> > (c) a statement indicating that a security interest is taken in all of the debtor's present and after-acquired personal property except specified items or kinds of personal property or except personal property described as "goods", "chattel paper", "securities", "documents of title", "instruments", "money" or "intangibles", or
> >
> > (d) a description of the collateral as inventory, but such a description is valid for the purposes of this section only while the collateral is held by the debtor as inventory.
>
> (2) A description is inadequate for the purposes of subsection (1) if it describes collateral as consumer goods or equipment without further reference to the kind of collateral.

Note: this section is the new collateral description requirement and will apply to all registrations where the collateral cannot simply be described by vehicle identification number (*i.e.* registrations relating to motor vehicles which are consumer goods, where such description is mandatory, or registration relating to motor vehicles which are not consumer goods and where the registrant has opted for such description). This provision is essentially identical to ss.36(2)-

(3) of the Alberta PPSA regulation.[11] It provides that each of the following is a sufficient description:

- an "item or kind" description of the collateral;
- a generic description of the collateral under certain broad descriptions ("goods" or "securities", for example);
- a "supergeneric" description of the collateral as including all of the debtor's present and after-acquired personal property;
- a supergeneric description, but excluding collateral which is described by item or kind or which is within a generic description; or
- a description as "inventory", but such description is ineffective if the collateral is or becomes classified other than as inventory.

It is clearly set out that the description is inadequate if it refers only to "consumer goods" or to "equipment" without a further description.

[11] Alta.Reg. 95/2001, as am.

# Schedule "B"

## Priority Between Accounts Receivable Financers & Inventory Financers

**Proposal: Ontario should adopt the approach taken by the Atlantic provinces to priorities between accounts receivable financers and inventory financers in respect of accounts receivable that constitute PMSI proceeds.**

## Background and Issue

The issue to be considered is whether to amend the Ontario PPSA ("OPPSA") to address priority contests between a secured party holding a perfected security interest in accounts receivable of a debtor (a "Receivables Financer"), either by way of security or through an absolute assignment, and an inventory financer (an "Inventory Financer") holding a perfected and duly notified purchase-money security interest ("PMSI") in accounts receivable of the same debtor that constitute proceeds of inventory subject to a PMSI generated by a sale of the inventory ("PMSI Receivables").

The ULCC Background Paper 2, prepared by Professor Buckwold for the Cuming-Walsh report, (the "Background Paper"), a copy of which is attached, sets out one way a Receivables Financer can come into conflict with an Inventory Financer in PMSI Receivables, as follows:

> A business debtor has financed the acquisition of inventory through either the extension of credit by the inventory supplier, or by procuring funds for the purchase of inventory from a third party lender. In either case, the financer acquires a purchase money security interest (hereafter, pmsi) in the inventory within the meaning of the definitions included in all Canadian PPSAs. The inventory financer perfects its security interest in inventory by registering a financing statement and otherwise complying with those requirements of the PPSAs conferring pmsi priority.
>
> Accounts receivable generated by sale of the inventory are "proceeds" of the original collateral, in which the inventory financer acquires a security interest by operation of law. That interest has the same status as the security interest in the original collateral, i.e., the inventory financer has a pmsi in the accounts receivable. The proceeds security interest in the accounts is perfected as a result of the prior registration of the financing statement, which included accounts in the description of collateral. In the result, the inventory financer has a perfected pmsi in the accounts receivable. [Footnotes omitted.]

Under the OPPSA, a Receivables Financer can protect itself against a prior existing Inventory Financer's security interest in inventory and PMSI Receivables by obtaining subordinations, releases or no-interest letters, as applicable.

More problematic for a Receivables Financer, however, is that, under the OPPSA, an Inventory Financer could take priority over a previously registered Receivables Financer's security interest in PMSI Receivables by reason of the super-priority accorded under section 33(1) to a PMSI in inventory or its proceeds and the fact that, under section 25(1), a security interest in collateral that gives rise to proceeds extends to the proceeds. The potential prejudice to Receivables Financers arises in part because under section 33(1)(b), in order to enjoy the super-priority for PMSIs, the Inventory Financer must give notice only to every other secured party who has registered a financing statement in which the collateral is classified as "inventory". There is no requirement to notify secured parties who have checked "accounts" but not "inventory". A Receivables Financer may, therefore, not know when or if its debtor (or seller) has granted a PMSI over inventory nor whether receivables generated by the sale of that inventory are subject to a prior-ranking security interest in favour of an Inventory Financer that has registered under the OPPSA after the date of the Receivables Financer's registration under the OPSSA. As a result, a Receivables Financer providing debt financing or a receivables purchase facility could unknowingly continue to finance on the security of, or purchase, such receivables, the value of which will have been considerably diluted by virtue of a first-priority security interest in favour of an Inventory Financer.

Receivables Financers can only partially deal with this problem by modifying their documentation (i.e., loan agreements or receivables purchase agreements). For example, in an asset-based loan agreement, the borrowing base will automatically exclude receivables subject to a prior security interest; however, the borrower may either not disclose the existence of a PMSI or may not even be aware that such disclosure is required on the erroneous assumption that the Receivables Financer would take priority by virtue of its prior registration. The problem may be compounded by a poorly drafted boilerplate "Permitted Liens" definition that includes purchase-money security interests.

The problem is even more acute for an asset securitization transaction, which involves an absolute assignment of receivables that is deemed to be a security interest under the OPPSA (as well as each of the other PPSAs across Canada). In a typical trade receivables securitization, for example, the securitization conduit purchases whole or undivided interests in all the "eligible receivables" generated by the seller. These purchases are effectively made on a daily basis during the term of the purchase facility, unless terminated earlier in accordance with the terms of the purchase agreement. Accordingly, it is necessary to do all required filings and to obtain releases, subordinations and/or no-interest letters from all competing or potentially competing secured parties in the purchased receivables. There is no easy mechanism for the purchaser to protect itself against a subsequent Inventory Financer with a PMSI priority in the PMSI Receivables. Receivables subject to a prior security interest (by reason of PMSI financing or otherwise) would typically be ineligible and, if purchased in contravention of these eligibility criteria, such ineligible receivables would be put back to the seller. However, aside from exposing the purchaser to seller credit risk, this regime only works in the case of receivables that are PMSI proceeds if the receivable in question has been properly identified as such. To the extent that receivables subject to a PMSI remain in the receivables pool (unbeknownst to the purchaser or the seller), the purchaser will have funded against some assets, the realizable value of which may be nil because they represent PMSI proceeds of an Inventory Financer.

## Possible Approaches

The Background Paper usefully summarizes the three approaches now used in Canadian PPSAs to address Inventory Financer and Receivables Financer priority disputes in PMSI Receivables:

> Option A:
>
> The inventory financer takes priority on the grounds that it holds a perfected pmsi in the accounts. Priority with respect to accounts generated as proceeds of inventory subject to a pmsi is determined on the same basis as priority with respect to other forms of proceeds of collateral of that kind. No special rule is required.
>
> This is the result under the Ontario PPSA.
>
> Option B:
>
> The inventory financer takes priority on the basis of its perfected pmsi in the accounts provided that it has given advance notice of its intention to take a pmsi in inventory to the accounts financer.
>
> This is the result under the PPSAs of the Atlantic provinces.
>
> Option C:
>
> The accounts financer has priority provided that it has given new value for its security interest in the accounts in question.
>
> This is the result under the PPSAs following the Model Act – i.e., those of the Western provinces and the territories
>
> This approach applies to accounts in any form that are proceeds of inventory, including deposit accounts in a financial institution, except in Saskatchewan, which excludes deposit accounts from the application of the rule.

**Recommended Approach**

We believe that, of the three options, Option B is preferable. Preserving the status quo through Option A is undesirable in that it leaves the problem essentially unresolved and perpetuates Ontario's growing isolation from the other PPSA jurisdictions. Option C, while attractive in its simplicity and its consistency with UCC Article 9, would in our view involve an unnecessarily radical departure from PMSI priority in inventory. It would essentially reverse the priority that the Inventory Financer would otherwise enjoy in proceeds if those proceeds happen to be represented by receivables rather than cash, chattel paper or other property without giving the Inventory Financer the opportunity to protect that priority. We see no clear benefit in so favouring Receivables Financers at the expense of Inventory Financers when the drawbacks of the existing regime can be remedied with the more modest adjustments required by Option B. In our view, Option B strikes a reasonable balance between the interests of Inventory Financers and

Receivables Financers by applying to this priority contest the same procedural approach applied to PMSIs in inventory generally – namely, an approach that allows the Inventory Financer to protect its interest in PMSI proceeds by giving notice to competing secured creditors and affords the Receivables Financer the opportunity to protect its security or ownership position when it receives the notice. This approach is consistent with one basic tenet of the PPSAs, which is to set out clear rules that establish priorities and then leave it up to the parties to order their own affairs to enjoy the benefit or avoid the effect of those rules.

The amendments needed to implement Option B are minimal. In section 33(1)(b) of the OPPSA, the words "in which the collateral is classified as inventory" would simply be amended to read "in which the collateral is classified as inventory or accounts". If the recommendation to replace the current "check the box" system with full collateral descriptions is adopted, then the amendments will also need to reflect the fact that a collateral description (rather than a collateral classification) will be required to be used in OPPSA filings. The manner in which the Atlantic provinces have dealt with this issue is helpful but not a complete answer,[1] because OPPSA registrations made prior to the elimination of the "check the box" system may only contain a collateral classification. Accordingly, we recommend that section 33(1)(b) of the OPPSA be amended to read as follows:

> "before the debtor receives possession of the inventory, the purchase-money secured party gives notice in writing to every other secured party who has registered, before the date of registration by the purchase-money secured party, a financing statement in which the collateral is classified as inventory or accounts or contains a description that includes the same item or kind of inventory or includes accounts."

It is true, as the Background Paper points out, that Option B may involve some additional administrative burden. Inventory Financers would need to send notices to secured parties that have, for example, checked the "accounts" box as well as those that have checked "inventory" box. In practice, we expect that this additional burden will be minimal. Sending such notices is a fairly mechanical clerical task and, in any event, borrowers typically do not have large numbers of lenders holding security over receivables and not inventory and sellers of trade receivables to securitization conduits or factors typically do not deal with more than one or two at a time. Some securitization conduits have in fact already imposed that burden on Inventory Financers. Counsel for some conduits have adopted the practice, with the consent of the seller, of checking "inventory" as well as "accounts" and "other" on financing statements registered to record the sale of receivables, precisely to ensure that the conduit receives notice of any PMSI financing in inventory.[2] The heavier administrative burden will likely be borne by the

[1] See e.g. New Brunswick PPSA s. 34(2)(b), which provides that the notice to be given by a purchase money financer of inventory to establish PMSI priority must be given to:

"...any other secured party who has registered, before the registration of the financing statement relating to the purchase money security interest in the inventory, a financing statement where the collateral description in the financing statement includes the same item or kind of collateral or includes accounts."

[2] The fact that some parties are motivated to "trick" the system in this way indicates, in our opinion, a flaw in the system.

recipients of the notices: lenders and receivables purchasers will have to develop policies and procedures to deal with PMSI notices. It is not self evident what action a purchaser of receivables should take when it receives a notice from an Inventory Financer that intends to take a PMSI in certain of the seller's inventory, which may not give rise to receivables for some time from account debtors that may not yet be identified. However, with the notice in hand, the Receivables Financer at least has some information on which it can make a more informed decision.

On balance, therefore, we believe that the Atlantic province model would work best under the OPPSA.

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## APPENDIX - ULCC BACKGROUND PAPER 2

# PRIORITY COMPETITIONS INVOLVING PROCEEDS OF INVENTORY: PMSI INVENTORY FINANCERS *VS.* ACCOUNTS FINANCERS

## I. CONTEXT

The issues addressed by this paper arise in the following scenario:

> *A business debtor has financed the acquisition of inventory through either the extension of credit by the inventory supplier, or by procuring funds for the purchase of inventory from a third party lender. In either case, the financer acquires a purchase money security interest (hereafter, pmsi) in the inventory within the meaning of the definitions included in all Canadian PPSAs. The inventory financer perfects its security interest in inventory by registering a financing statement and otherwise complying with those requirements of the PPSAs conferring pmsi priority.*
>
> Accounts receivable generated by sale of the inventory are "proceeds" of the original collateral, in which the inventory financer acquires a security interest by operation of law.[1] That interest has the same status as the security interest in the original collateral, i.e., the inventory financer has a pmsi in the accounts receivable.[2] The proceeds security interest in the accounts is perfected as a result of the prior registration of the financing statement, which included accounts in the description of collateral.[3] In the result, the inventory financer has a perfected pmsi in the accounts receivable.
>
> - Variation 1: The debtor has procured funds for other purposes from a lender who has taken a security interest in (or security assignment of) the debtor's accounts. The accounts financer has perfected its security interest by registering a financing statement *before* the financing statement was registered by the inventory financer.

[1] The *PPSAs* of all jurisdictions provide that a security interest taken in original collateral extends to its proceeds. See *e.g.* Saskatchewan *PPSA* s. 28(1).

[2] See *e.g.* Saskatchewan *PPSA* s. 34(3), which confers priority on "a purchase money security interest in inventory *or its proceeds*".

[3] See *e.g.* Saskatchewan *PPSA* s. 28(2).

- *Variation 2:* The debtor has sold and assigned its accounts receivable to a third party. The assignee has registered a financing statement relating to the assignment of accounts *before* the financing statement was registered by the inventory financer.[4]

The inventory financer and the accounts financer (in *Variation 1*) or assignee (in *Variation 2*) both claim priority with respect to the accounts.

## II. CURRENT LAW

There are, among the *PPSAs* of the Canadian provinces and territories, three different approaches to resolution of these priority disputes. In each case, a single priority rule applies to both security interests taken by an accounts financer in the debtor's accounts (*Variation 1*) and absolute assignments of accounts (*Variation 2*).[5] The three options currently represented by the *PPSAs* may be summarized as follows:

### Option A:

The inventory financer takes priority on the grounds that it holds a perfected *pmsi* in the accounts. Priority with respect to accounts generated as proceeds of inventory subject to a *pmsi* is determined on the same basis as priority with respect to other forms of proceeds of collateral of that kind. No special rule is required.

This is the result under the Ontario *PPSA*.

### Option B:

The inventory financer takes priority on the basis of its perfected *pmsi* in the accounts *provided that* it has given advance notice of its intention to take a *pmsi* in inventory to the accounts financer.

This is the result under the *PPSAs* of the Atlantic provinces.[6]

### Option C:

[4] Registration of a financing statement is necessary to protect the interest of the assignee under the *PPSAs* of all jurisdictions except Ontario. However, assignees may elect to register in Ontario in order to avoid potential issues arising from the question of whether the transaction is or is not in substance a security agreement.

[5] See *e.g.* Saskatchewan *PPSA* s. 3(2), Ontario *PPSA* s. 2(1)(b), providing that the *Act* applies to a transfer of an account that does not secure payment or performance of an obligation – *i.e.*, that is not in substance a security agreement.

[6] See *e.g.* New Brunswick *PPSA* s. 34(2)(b), which provides that the notice to be given by a purchase money financer of inventory to establish the *pmsi* priority must be given to;

> *"...any other secured party who has registered, before the registration of the financing statement relating to the purchase money security interest in the inventory, a financing statement where the collateral description in the financing statement includes the same item or kind of collateral or includes accounts."*

The accounts financer has priority *provided that* it has given new value for its security interest in the accounts in question.

This is the result under the *PPSAs* following the Model Act – *i.e.*, those of the Western provinces and the territories.[7]

This approach applies to accounts in any form that are proceeds of inventory, including deposit accounts in a financial institution, except in Saskatchewan, which excludes deposit accounts from the application of the rule.[8]

### Civil Code

The Civil Code represents a distinct approach to the scenario as it might arise in Quebec. Under Quebec law, a security interest in inventory does not extend to or continue in the accounts receivable generated by sale of that inventory. The inventory financer may only acquire an interest in those accounts by taking a security interest in them as original collateral. A priority dispute over the accounts is accordingly determined on the basis of first to register. In the scenario given, the accounts financer would win. The result is therefore essentially the same as that produced by Option C above.

The Study Committee has identified two issues that arise in the context of this inter-provincial diversity of approaches. (1) Which of the approaches is to be preferred as the basis for a harmonized approach? and (2) Is harmonization desirable?. The Committee was not able to reach a consensus on Issue 1. However, given its tentative conclusion on Issue 2, it is of the view that consensus may not be necessary.

## ISSUE 1: WHICH APPROACH IS PREFERRABLE?

### Option A: (Ontario PPSA)

The positives of this approach include following:

- it maximizes the security position of purchase money inventory financers.

[7] The relevant provision of the Model Act (see also *e.g.* Saskatchewan *PPSA* s. 34(6)) is as follows:

> *34.(6) A non-proceeds security interest in accounts that is given for new value has priority over a purchase-money security interest in the accounts as proceeds of inventory if a financing statement relating to the security interest in the accounts is registered before the purchase money security interest is perfected or a financing statement relating to it is registered.*

[8] See Saskatchewan *PPSA* s. 34(7).

- it imposes no special notice or registration requirements on inventory financers who wish to claim accounts generated by the sale of inventory as collateral. That is, nothing is required supplementary to the general notice upon which *pmsi* priority in inventory is based.[9]

- it applies the same priority rule to all proceeds of inventory that is subject to a *pmsi*, regardless of their form (*i.e.,* whether accounts receivable, deposit accounts, chattel paper, trade-ins or otherwise).

The negatives of this approach include the following:

- it limits the ability of accounts financers to predict and manage their lending risk, particularly in connection with future accounts. Their priority position *vis-à-vis* any given account generated by sale of the debtor's inventory will depend upon whether that account is proceeds of inventory subject to a *pmsi* As a consequence, accounts financers may refuse to lend on the security of future accounts or may overcollateralize against accounts, thereby reducing the credit available to the debtor.

- a purchaser of accounts who takes an absolute assignment may lose its entitlement to those accounts to an inventory financer in spite of having paid for them and having properly registered a financing statement. The potential for this to occur may impede securitization of accounts (*i.e.*, the sale of accounts in bulk by the original holder or an assignee).

- the assumption that inventory financers depend upon accounts receivable as a source of security may be disputed. The legislatures of the Western provinces and, to a somewhat lesser degree, the Atlantic provinces have acted on the view that inventory financers other than banks and credit unions are not ordinarily equipped or inclined to deal with accounts as collateral. To the extent that they rely on proceeds, inventory financers are regarded as more likely to look to trade-ins and chattel paper.[10] On this view, the protection of inventory financers' rights to accounts receivable arising as proceeds is unwarranted.

- funds supplied by the accounts financer are not infrequently used to pay the inventory financer. In such circumstances, the accounts financer is unfairly disadvantaged by loss of the accounts to the inventory financer.

- it is inconsistent with the approach taken under Quebec law.

- it is inconsistent with the priority rule represented by revised section 9-324 of Article 9 of the Uniform Commercial Code, which adopts the approach embodied in option 3.

[9] See Ontario *PPSA* s. 33(1)(b) and to similar effect Saskatchewan *PPSA* s. 34(3)(b).

[10] In Saskatchewan, they may also look to cash proceeds of inventory, including deposit accounts. See note 8.

**Option B: (Atlantic Provinces)**

The positives of this approach include the following:

- it enables purchase money financers of inventory to protect their claim to accounts generated by sale of the inventory if they wish to do so, by giving notice to previous accounts financers and purchasers who have registered a financing statement.
- it assists accounts financers in their risk management assessment and practices by enabling them to better predict their priority position with respect to accounts receivable generated by sale of the debtor's inventory.
- it offers some protection to accounts purchasers who take absolute assignments of accounts.
- it attempts to balance the interests of account and inventory financers.

The negatives of this approach include the following:

- since accounts financers cannot establish an indefeasible priority position with respect to future accounts of a debtor, they may be unwilling to lend on the basis of security in accounts or may overcollateralize, thereby limiting the debtor's borrowing facility.
- the inability of accounts purchasers to establish indefeasible priority may impede securitization of accounts.
- the notice requirement associated with protection of the *pmsi* priority in accounts involves an additional administrative burden and creates transactional inefficiency.
- resolution of priority disputes is complicated by the need to establish by appropriate evidence whether or not notice was properly given by the inventory financer to previously registered accounts financers or purchasers.
- like Approach 1, this approach rests on the (debatable) assumption that accounts receivable are an important source of collateral for inventory financers, as compared with prior accounts financers.
- like Approach 1, this approach is not consistent with that taken by Quebec law.
- like Approach 1, this approach is inconsistent with the priority rule adopted by Article 9 of the Uniform Commercial Code.

**Option C: (Western provinces, the territories and Quebec)**

The positives of this approach include the following:

- it facilitates a business borrower's access to financing through accounts financers by assuring the latter of priority without restricting (significantly or arguably at all) the availability of purchase mbney financing. Inventory financers may rely on other forms of proceeds, as well as their original collateral.[11]

- it fully protects purchasers of accounts. It therefore facilitates the increasingly prevalent practice of securitization of accounts.
- it is comparable to that taken under Quebec law.
- it is consistent with revised Article 9 of the Uniform Commercial Code and thus with the law of the American states.

The negatives of this approach include the following:

- it limits the security available to purchase money financers of inventory.
- it rests in part on the potentially debatable view that inventory financers do not rely heavily on accounts generated by the sale of inventory as collateral, and that it therefore does not significantly limit the availability purchase money financing.

## ISSUE 2: IS HARMONIZATION DESIRABLE?

It is widely accepted that uniformity in the law across Canadian jurisdictions is generally desirable, especially in the commercial realm. Ideally, a single rule would determine priority in all jurisdictions in competitions between accounts financers and purchase money inventory financers claiming accounts as proceeds. However, the Study Committee is aware of no compelling evidence suggesting that the current diversity of approaches is creating significant difficulty, either in terms of legal uncertainty or in terms of the availability of credit to business debtors. While uniformity on this point is no doubt desirable, it may not be essential.

**PLEASE OFFER YOUR VIEWS ON THE QUESTIONS RAISED IN THIS PAPER BY SUBMITTING YOUR RESPONSE TO THE QUESTIONNAIRE.**

**[Go to Questionnaire 2]**

[11] In Saskatchewan they may also assert priority with respect to cash proceeds, including proceeds in the form of deposit accounts. See note 8.

# Schedule "C"

## Creation of Permanent Advisory Committee

**Ontario should commit to, and enshrine in the PPSA, a permanent reform process.**

The proposal for reform.

I propose that a new section be added to Part VI of the PPSA which would provide for the creation of a permanent advisory committee with respect to PPSA reform. As a first attempt for discussion purposes only, I submit the following draft of a new section 73.2:

> **73.2 (1) Minister's Advisory Committee. – The Minister responsible for the administration of this Act shall appoint a permanent advisory committee with respect to revision and reform from time to time of this Act, to be referred to as the "Minister's Advisory Committee with respect to the PPSA".**
>
> **(2) Definitions. – In this section, "Committee" means the committee established under subsection (1), and the "Minister" means the Minister responsible for the administration of this Act.**
>
> **(3) Powers of Minister. – The Minister may make orders,**
>
> **(a) appointing, removing or replacing members of the Committee;**
>
> **(b) directing the Committee to prepare reports, recommendations or research papers with respect to particular matters affecting this Act;**
>
> **(c) governing the operation of the Committee generally.**
>
> **(4) Not regulations. – An order made by the Minister under subsection (1) is not a regulation within the meaning of the *Regulations Act.***
>
> **(5) Considerations for Minister. – In exercising the powers of the Minister with respect to the Committee provided for in this section, and in considering any recommendations of the Committee, the Minister shall have due regard to the following:**
>
> **(a) the need for Ontario's commercial law and this Act to be continually modernized and updated;**
>
> **(b) the need for Ontario's commercial law and this Act to reflect appropriately the interests of all those affected by it, including but not only consumers, businesspersons and entrepreneurs, persons engaged in agriculture and agri-business, the financial services and securities sectors, and their respective professional advisors;**

> **(c) the need for Ontario's commercial law and this Act to respond to developments in other Canadian jurisdictions and in other countries and, where appropriate and in the interests of Ontario, to harmonize the provisions of this Act with those of similar legislation in other jurisdictions;**
>
> **(d) the need for Ontario to participate in significant interjurisdictional and international law reform processes relating to the subject-matter of this Act.**

The rationale for the proposal.

*Rationale provided in the 1998 Submission.* Our 1998 Submission[1] set out the rationale for an ongoing reform process. In that Submission, we specifically mentioned that the Minister may wish to reconstitute the prior Minister's Advisory Committee, or consider a reform process akin to that in the United States in respect of the UCC or participation in interjurisdictional reform processes in Canada (*e.g.* those of the Uniform Law Conference of Canada).

We pointed out at that time that our Subcommittee's volunteer membership was limited in its financial and other resources. I think the fair inference to take from this was that some kind of "official" process was needed.

*Subsequent developments.* To me, it is now apparent that two assumptions we have made in the past when addressing PPSA reform have been thoroughly disproved: first, that PPSA reform can be dealt with on a "housekeeping" level, *i.e.* on the basis of a set of discrete recommendations and studies that will have a fixed lifespan, be discussed by stakeholders, and then finally implemented or rejected in a finite process; and second, that "made in Ontario" solutions are possible for this area of reform.

If one looks at the matters our Subcommittee has been involved in recently, they are not of the sort prevalent in earlier years where a particular statutory problem emerged in the case law and could be clarified or "fixed" by specific amendments. These have been broader issues such as the impact on the PPSA of the USTA, the need to respond to Article 9 reform, the desirability (or lack thereof) of harmonization with the Western Model/CCPPSL Model PPSA, and the need to reflect international developments in movable goods and receivables law reform. I do not think there is any basis to believe that either the pace or complexity of these issues will slacken significantly.

To me, this suggests powerfully that we have to have a permanent, "expert" group that is involved and stays involved in PPSA-related issues and is both (i)

[1] Recommendation 36 (pages 40-41).

recognized as such and not as a lobby group and (ii) able to respond quickly to emerging issues. This is impossible if individual groups such as ours, no matter how well-intentioned, form *ad hoc* groups to look at these issues in isolation.

*Location of section and drafting considerations.* Part VI of the Act contains the "Miscellaneous" provisions, and presently includes provisions relating to knowledge and notice under the PPSA, the general powers of the courts under the Act (as well as their specific powers with respect to extension and abridgement of time), specific provisions respecting the destruction of registry records, the provisions relating to the preservation of the general principles of law and equity, and the provisions determining the position of the PPSA in conflict with other Acts. It also includes, however, the regulation-making powers of the Minister which were in 1998 bifurcated into separate sets of order-making powers (s.73.1) and regulation-making powers (s.74) by the *Red Tape Reduction Act, 1998.*[2]

I propose to locate the provisions relating to the proposed Advisory Committee between these sections to include them as a new, but separate, part of the Minister's order-making power. The goal in doing so is to allow the Minister significant flexibility, but still provide in the PPSA itself that the committee must exist and set out the purposes for its work and the considerations it should be bringing to bear on the issues it deals with.

Further research and consultation requirements.

I do not believe that any further research on this proposal is required. Clearly significant further consultation would be required, beginning in the Ministry itself to determine its willingness to make this commitment, and then proceeding to consultation with all affected stakeholders to determine the composition and particular mandate(s) of the advisory committee. Note that this second stage need not occur before the legislative change proceeds, however.

David L. Denomme

[2] S.O. 1998, c. 18; see s.200 of Schedule E for the addition of s.73.1 of the present PPSA.

# Schedule "D"

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**Updated: April 24, 2006**

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