True Consignments:

A proposed amendment to *Personal Property Security Act* to avoid priority problems arising from interaction with the *Factors Act*

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Submitted by: Ontario Bar Association, Personal Property Security Law Committee

ONTARIO BAR ASSOCIATION
A Branch of the Canadian Bar Association

L'ASSOCIATION DU BARREAU DE L'ONTARIO
Une division de l'Association du Barreau canadien

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Introduction

The Ontario Bar Association (the "**OBA**") appreciates the opportunity to provide this submission to the Ministry of Government and Consumers Services (the "**Ministry**") on proposed amendments to the *Personal Property Security Act* (the "**OPPSA**").

The OBA believes the proposed statutory amendments would avoid potential priority problems that consignors may face as against a consignee's secured creditors as a result of the interaction of the *OPPSA* and the *Factors Act (Ontario)* (the "**FA**").

The OBA

Established in 1907, the OBA is the largest voluntary legal association in Ontario and represents approximately 16,000 lawyers, judges, law professors and law students. The OBA is pleased to analyze and assist government with dozens of legislative and policy initiatives each year - both in the interest of the profession and in the interest of the public.

Nearly 1,700 OBA members belong to our active Business Law Section (the "**Section**"). This submission was prepared by the Section's Personal Property Security Law Committee (the "**Committee**"), which includes the leading experts in personal property security law. The OBA's Business Law Section and the Committee have assisted government with virtually every reform in the area of personal property security law. A list of the current members of the Committee is attached as Appendix A. In addition, representatives of the Ministry and the OBA often attend meetings of the Committee as observers.

Comments

Overview

This submission addresses the power of a "true" consignee-agent to give a security interest in the consigned goods to secure value given to the consignee-agent. The specific issue is the potential for such a security interest to prevail over the consignor's ownership right. The proposed statutory amendment is designed to limit such power, which the Committee considers, in general, to be neither desirable nor intended. The issue arises from an interaction between certain provisions of the FA and the OPPSA and the exclusion of true consignments from the scope of the OPPSA.

This submission is divided into three parts. Part I discusses the exclusion of "true" consignments from the scope of the OPPSA and compares this approach to the approaches taken in other jurisdictions in Canada and the United States. Part II discusses the potential priority problem that

consignors may face as against a consignee's secured creditors as a result of the interaction of the FA and the OPPSA and the exclusion of true consignments from the scope of the OPPSA. Part III sets forth the Committee's proposed statutory amendment to the OPPSA to deal with this potential priority dispute.

I. Application of OPPSA to Consignments

"Consignment" is not defined in the FA or the OPPSA. For the purposes of this submission, it is a transaction under which one person (the "consignor") delivers goods to another person (the "consignee") for sale to third parties. Ownership does not pass to the consignee. When the goods are sold to third parties, the consignee is acting as the consignor's agent. When an authorized sale of the consigned goods is made by the consignee, title passes directly from the consignor to the buyer. As well, upon the sale of the consigned goods, the consignee becomes accountable to the consignor for the proceeds of the sale (subject to an agreed upon commission). In contrast to a debtor in a secured purchase transaction, the consignee is not liable to the consignor for the value of the unsold consigned goods.[1]

Typically, in an inventory financing, goods are delivered to the debtor, who undertakes to pay the financier the outstanding financed amount. As under a consignment arrangement, the expectation is that the debtor will pay the secured creditor out of the proceeds of the sale of the goods to the public. However, unlike under a consignment arrangement, the debtor will be required to pay the secured party the outstanding amount by a certain date, whether or not the goods have been sold by the debtor. Like the consignor, the secured party is entitled to repossess unsold goods, and yet unlike a repossessing consignor, a repossessing secured party is enforcing its rights against a defaulter and, unless otherwise provided in the security agreement, is entitled to any deficiency in the case of a shortfall in the value realized in the sale of the repossessed goods.

A "consignment" may look very much like a "non-recourse inventory financing" arrangement, under which a secured party forgoes its right to a deficiency and undertakes to look only to the return of the goods to it as a way of compensating itself in case the debtor defaults (for example, because the goods are not sold).

Section 2(a)(ii) of the OPPSA states that the OPPSA applies to a "consignment that secures payment or performance of an obligation". Such a transaction would require the consignee to pay the consignor the full value of the goods, whether or not sold by the consignee, such that the transaction "in substance creates a security interest" and, as such, is not a "true" consignment. A

[1] By contract (and otherwise under the laws of agency and bailment), the consignee owes certain duties to the consignor with regard to the safekeeping of the consigned goods, but these duties are outside the scope of this submission.

"true" consignment agreement is not governed by the OPPSA, because the consignor's property right is that of outright ownership and not a "security interest".[2]

Thus, a "true" consignor is not required to comply with the OPPSA to protect its property interest in the consigned goods. Moreover, pursuant to Section 46(5)(b) of the OPPSA, even if the consignor under a true consignment registers a financing statement in respect of such true consignment, such registration does not create a presumption that the OPPSA applies to such consignment transaction, if the interest created thereunder is otherwise excluded from the scope of the OPPSA.

The rationale behind the exclusion of a "true" consignment from the OPPSA appears to be threefold:

1. A "true" consignment transaction does not give rise to a security interest; hence, there must be some persuasive reason to nevertheless bring such a transaction within the ambit of the OPPSA.

2. However, unlike for example, distinguishing a "true lease" from "a lease that secures payment or performance of an obligation"[3], it appears from the paucity of case law that distinguishing a "true" consignment transaction from a secured transaction (or, as provided in Section 2(a)(ii) of the OPPSA, a "consignment that secures payment or performance of an obligation") has not been heavily litigated, possibly due to the use by Ontario courts of a two-step test to determine whether or not a transaction is a security consignment that has made the distinction conceptually clearer.[4] Accordingly, there is no compelling reason to deem a true consignment transaction to be a security interest, as there has always been in the case of an absolute transfer of accounts or chattel paper[5] or since 2007 in the case of a lease of goods under a "lease for a term of more than one year".[6]

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[2] Section 1(1) of the OPPSA defines "security interest" in part as "an interest in personal property that secures payment or performance of an obligation".
[3] Section 2(a)(ii) of the OPPSA.
[4] For example, in *Access Cash International Inc.* v. *Elliot Lake and North Shore Corp. for Business Development*, [2000] O.J. No. 3012, the Ontario Superior Court stated (at para. 10) that: "It is generally accepted that determining whether the PPSA applies [to a consignment agreement] involves a two-part test. First, is the arrangement between the parties truly a consignment as opposed to a sale? Second, if it is a consignment agreement, does it secure payment or performance of an obligation?" Many agreements that are labelled a "consignment agreement" may, on a closer review of the terms and the parties' conduct, be viewed as being a sale transaction (e.g., unconditional contract of sale or an agreement of sale on approval or return), in which case the "consigned" goods will become the property of the "consignee".
[5] See Section 2(b) of the OPPSA and paragraph (a) of the definition of "security interest" in Section 1(1) of the OPPSA. Even before the OPPSA came into force in Ontario in 1976, the old *Assignment of Book Debts Act* (Ontario) extended the scope of such statute to certain absolute assignments of book debts, because of the difficulty of distinguishing absolute assignments from assignments by way of security.
[6] See Section 2(c) of the OPPSA and paragraph (b) of the definition of "security interest" in Section 1(1) of the OPPSA.

3. If a "true" consignment transaction had been deemed to be a security interest under the OPPSA, then a consignor would need to take the following actions to assure itself of the priority of its interest in the consigned goods:

   (1) properly register a financing statement in respect of such transaction against the legal name of the consignee;
   (2) because such a transaction would be regarded as an inventory financing, comply with all applicable PMSI in inventory formalities in section 33(1) of the OPPSA; such formalities include (i) conducting OPPSA searches against the current and all former legal names of the consignee and (ii) if such searches disclose any secured parties with competing or potentially competing security interests in the consigned goods or the accounts of the consignee (each, a "Prior SP"), ensuring that PMSI notices are received or are deemed to have been received by each such Prior SP before any of the consigned goods are delivered to the consignee; and
   (3) if any of the above actions is not strictly complied with, obtain a priority agreement from each such Prior SP.

Except for the most sophisticated consignors involving expensive consigned goods, it is not realistic to expect that consignors will be able to properly complete these actions, without the assistance of legal counsel. Moreover, in most "true" consignment transactions, the costs to consignors of retaining legal counsel may be impractical and uneconomical.

By not including true consignments within the scope of the OPPSA, Ontario has gone its own way. The *Personal Property Security Acts* (each, a "**PPSA**") of the other provinces of Canada (the "**Other PPSA Provinces**") and Article 9 of the United States Uniform Commercial Code (the "**UCC**") have included "true consignments" within the scope of their legislation, although certain consignments remain outside the scope of such legislation (as described later in this Part).

One rationale for inclusion would be the difficulty of distinguishing a true consignment from a "non-recourse inventory" financing described above. Moreover, in the eyes of third parties (including the consignee's creditors), the consignor's property right, though genuinely ownership, is no different from any other "secret lien" and thus ought to be subject to registration like a "true" security interest. As well, proponents of inclusion may have had less faith in the ability of courts to easily determine whether a given arrangement is in fact a "true consignment" or "consignment that secures payment or performance of an obligation".

In the Committee's view, these considerations are not strong enough to outweigh the original reasoning against treating the consignor's right as a deemed security interest. Indeed, each of the PPSAs in the Other PPSA Provinces and the UCC purports to exclude small scale consignments made by non-professional consignors. However, in view of the Committee, given the lack of case law in Ontario on distinguishing true consignments from security consignments, it appears that a solution

has been adopted by the Other PPSA Provinces to solve a problem that does not seem to exist in Ontario.

II. Priority Disputes between Consignors and Consignees' Secured Creditors

The Committee has determined that, in one important context, the exclusion of "true" consignments from the scope of the OPPSA puts consignors with consigned goods in Ontario at a disadvantage (as compared to their position in the Other PPSA Provinces if they have properly completed their PPSA registrations and satisfied the PMSI formalities) and at risk of losing their property rights with no ability to protect themselves as against secured creditors of their consignees. The Committee acknowledges that it is not aware of any reported Ontario cases in which consignors have lost priority disputes as a result of not being able to protect themselves under the OPPSA; but this may well be because the consignors most vulnerable to losing out to a secured creditor are unlikely to have the resources to fund an effective defence in the face of a statutory provision that clearly favours the secured creditor.

A trustee-in-bankruptcy of the consignee or a judgment creditor of the consignee who has seized the consigned goods will not be able to defeat the interest of the consignor in the consigned goods pursuant to Section 20(1)(b) and Section 20(1)(a)(ii), respectively, of the OPPSA, because the interest of a true consignor in its consigned goods is outside the scope of the OPPSA. However, by virtue of a little known provision in the FA, a consignor will not be protected against a secured party of the consignee, irrespective of perfection, if such secured party acquires its rights in the consigned goods in good faith and without notice.

The FA deals with, among other things, the power of a "mercantile agent", who is in possession of the goods with the consent of the owner of such goods, to confer title to a buyer from the mercantile agent. The FA does not define "consignment" or any derivative thereof. Yet, this is, in fact, the type of arrangement that is covered by the FA. Nor does the FA mention "factor" but instead uses the broader term "mercantile agent". The term "mercantile agent" is defined in Section 1(1) of the FA to mean "a mercantile agent having, in the customary course of business as an agent, authority either to sell goods or to consign goods for the purpose of sale, or to buy goods, or to raise money on the security of goods."

For present purposes, the key provision of the FA is Section 2(1), which deals with the power of a "mercantile agent" (which would include a consignee) to potentially extinguish the rights of the owner (or, in this case, the consignor):

> "Where a mercantile agent is, with the consent of the owner, in possession of goods or of the documents of title to goods, a *sale, pledge or other disposition of the goods* made by the agent when acting in the ordinary course of business of a mercantile agent is, subject to this Act, as valid as if the agent were expressly authorized by the owner of the goods to make the

> disposition, if the person taking under it acts in good faith and has not at the time thereof notice that the person making it has not authority to make it." [emphasis added]

In protecting good faith purchasers who *buy* the goods from the consignee, the provision implements the same policy as Section 28(1) of the OPPSA. Certainly, the Committee sees no difficulty with this aspect of Section 2(1) of the FA.

The difficulty is that Section 2(1) of the FA also protects a taker by "pledge or other disposition". This wording appears to be broad enough to include a transaction that creates a security interest in the goods. Certainly, a "pledge" is the same as a transaction under which a possessory security interest is given.[7] As for secured transactions in general, particularly ones under which non-possessory security interests are granted, it has been held that a loan agreement may give rise to a "disposition" where it provides for title to a vehicle to pass to a creditor if a debtor defaults on repayments.[8] Possibly, any transaction that involves more than a mere transfer of possession will qualify.[9]

True, there is no voluminous case law on point. There is some judicial support for the proposition that a chattel mortgage is a "disposition" within the meaning of the FA.[10] More generally, the ordinary meaning of "disposition", not to mention the specific meaning of pledge, would support the inclusion of a transaction under which a security interest is given.[11]

There are no strong arguments or protective actions that can be made or taken by true consignors that will be effective against the claims of a secured creditor of the consignee with a security

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[7] The word "pledge" is defined in s. 1(1) of the FA as including "a contract pledging or giving a lien or security on goods …".

[8] See *Dodds v Yorkshire Bank Finance Ltd,* [1992] C.C.L.R. 92, CA, as cited in H*alsbury's Law of England, Consumer Credit* (Volume 9(1))(Reissued) [2] (8)(55)

[9] cf. *Worcester Work Finance v. Cooden Engineering Co.* [1972] 1QB 210.

[10] See, e.g., *Industrial Acceptance Corporation Ltd. v. Whiteshell Finance Corporation Ltd.* (1966), 57 D.L.R. (2d) 670 (Man QB) (chattel mortgages being held to be "dispositions" protected by the Manitoba counterpart to Section 2(1) of the FA); and *Fuhrmann v. Miller (sub nom. Re Fuhrmann and Miller),* (1977), 16 O.R. (2d) 429, 78 D.L.R. (3d) 284 (Ont. S.C. in Bkcy) (chattel mortgage being held to constitute a "disposition" within the meaning of s. 25(2) of the *Sale of Goods Act* (Ontario), which is framed in terms similar to section 2(1) of the FA: "Where a person having bought or agreed to buy goods obtains, with the consent of the seller, possession of the goods or the documents of title to the goods, the delivery or transfer by that person, or by a mercantile agent acting for that person, of the goods or documents of title, under a sale, pledge or other disposition thereof to a person receiving the goods or documents of title in good faith and without notice of any lien or other right of the original seller in respect of the goods, has the same effect as if the person making the delivery or transfer were a mercantile agent in possession of the goods or documents of title with the consent of the owner."

[11] In *Patry v. General Motors Acceptance Corp. of Canada*, [2000] O.J. No. 1618 at para. 13, the Ontario Court of Appeal held, in *obiter*, that if the arrangement in that case had been a true consignment the chattel mortgage granted by the true consignee/dealer to its lender was a pledge under s. 2(1) of the FA and such lender's security interest would prevail over the owner's interest in such consigned goods.

interest in the consignee's inventory or accounts (perfected or not) where the secured creditor has the benefit of Section 2(1) of the FA. An inventory secured party (including a consignor under a security consignment) can avoid the adverse effects of Section 2(1) of the FA by registering a financing statement under the OPPSA and by sending PMSI notices to all of the consignee's secured parties claiming a security interest in the consignee's inventory or accounts. In contrast, if true consignors were to take such actions, they would not be effective, because true consignments fall outside the scope of the OPPSA. As a result, true consignors cannot rely on the super-priority rules for a PMSI in inventory.

Moreover, this priority dispute is not an example of a conflict between the OPPSA and the FA, in which case, the OPPSA would prevail under Section 73 of the OPPSA. The provisions of both statutes can exist in harmony, albeit with a result that sacrifices the rights of the consignor to those of the consignee's secured creditors. Effectively then, if a secured party takes a security interest in the consigned goods from the consignee, subject to and in accordance with the conditions specified in Section 2(1) of the FA, that secured party may defeat the title of the consignor (owner). As far as the FA is concerned, there is not even a perfection requirement to be complied with by the consignee's secured party.

It is clear that, from the perspective of the OPPSA, a consignee taking the benefit of Section 2(1) of the FA has a sufficient interest in the consigned goods to grant a security interest in them. For "attachment" to occur under Section 11(2) of the OPPSA, the debtor must have "rights in the collateral *or the power to transfer rights in the collateral to a secured party*" [emphasis added].

Pursuant to Section 2(1) of the FA, a consignee has the power to give a valid security interest in the consignor's goods. However, the priority of such a security interest under the OPPSA over the consignor's ownership interest is not all that clear.

Except for the limited categories of competing claimants listed in Section 20(1) or Section 28 of the OPPSA, the OPPSA in general governs the priorities amongst competing security interests, not between security interests and ownership interests.

The consignor is not a secured party and thus could not have protected itself by the registration of a financing statement. At the same time, there is nothing in the OPPSA to provide for the priority of a perfected security interest in consigned goods over the ownership interest of the consignor. There is an ambiguity under the OPPSA in relation to the position of the consignor against which it cannot protect itself. Nor is the common law of much assistance.

In the absence of Section 2(1) of the FA, if the consignee granted a security interest in the consigned goods, without the consignor's consent, and the secured party purported to realize on that security by selling or foreclosing on the consigned goods, the consignor could have a claim in conversion or an action for replevin against the consignee and its secured party. But if the requirements of Section 2(1) of the FA are satisfied, no such remedy would be available.

The Committee is not aware of any valid policy grounds under which, as against the consignee's creditors, a "true" consignor should be assigned a priority position with respect to the consigned goods that is worse than that of an inventory-PMSI holder with respect to the PMSI goods held by the consignee (namely, the PMSI holder's debtor). Accordingly, the Committee has developed a recommendation to revise the Ontario statutory scheme so that, with respect to goods held by the consignee, a "true" consignor will have protection at least comparable to that afforded to a secured party with a PMSI in inventory.

III. Solving the Priority Issue between Consignors and Consignees' Secured Creditors

The Committee extensively discussed the pros and cons of including "true" consignments within the OPPSA. However, for the reasons previously given by the Committee in its 1998 Submission,[12] the Committee was not persuaded by the position adopted by the Other PPSA Provinces or under the UCC.

The Committee also considered and rejected some other options, including the following two proposals:

(1) The first proposal would have required the consignor to register under the OPPSA, but only in order to protect the consignor against competing secured parties of the consignees. Under this proposal, the consignor would remain protected against the consignee's trustee in bankruptcy and judgment creditors even without registration. This proposal failed to gain support as it could expose unsophisticated consignors (who were unaware of the OPPSA registration requirement) to the risk of losing out to more sophisticated secured parties.

(2) The second proposal would have conferred on the consignor a deemed perfected PMSI holder position, without requiring the consignor to make any OPPSA registration. The Committee viewed this proposal as too intrusive on the scheme of the OPPSA and as a possible invitation to other groups to press for such a status for specific types of security interests or other transactions that raise difficult characterization issues under the OPPSA.

Ultimately, the Committee decided against resolving the matter as a priority contest within the PPSA itself. Instead, the view that prevailed was that this is a matter to be resolved by neutralizing

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[12] Canadian Bar Association-Ontario, *Submission to the Minister of Consumer and Commercial Relations Concerning the Personal Property Security Act* (October 21, 1998) at p. 9: "While it would be logically consistent to include . . . [commercial] consignments, on balance the Committee is of the view that this is not a pressing issue. We are also concerned that such a change could be a trap for unwary individuals such as artisans or craftspersons who consign goods on a regular basis to retail merchants, and who would not likely be aware of the perfection requirements."

Section 2(1) of the FA, with respect to grants of unauthorized security interests in the consignor's goods by the consignee.

In this framework, the initial thought of the Committee was to resolve the problem in the form of an amendment to the statute that gives rise to the problem, namely the FA. However, upon further consideration, the Committee realized that Section 73 of the OPPSA may pose a problem. This section provides that, in the case of a conflict between a provision of the OPPSA and any provision of any other Act (other than the *Consumer Protection Act*), the OPPSA provision prevails.

The concern is that, as long as the mercantile agent retains some authority to give a security interest in the goods (as when that person is so authorized to do so), Section 11(2) of the OPPSA will treat that person as having the power to grant a security interest in the consigned goods, and due to the paramountcy assigned by Section 73 of the OPPSA to the OPPSA over the FA, an amendment in the FA may not be effective to supersede this interpretation of Section 11(2) of the OPPSA.

Accordingly, the final decision was to neutralize the impact of the FA by providing for it in the OPPSA.

The amendment proposed below must be read against the background of the following provisions:

- the definition of a "mercantile agent" under Section 1(1) of the FA:

  > "mercantile agent" means a mercantile agent having, in the customary course of business as an agent, authority either to sell goods or to consign goods for the purpose of sale, or to buy goods, or to raise money on the security of goods.

- Section 11(2) of the OPPSA: " ... a security interest ... attaches to collateral only when value is given, the debtor has *rights in the collateral or the power to transfer rights in the collateral to a secured party* ..." [Emphasis added]

- <u>Section 2(1) of the FA:</u>

  > **2.**(1) Where a mercantile agent is, with the consent of the owner, in possession of goods or of the documents of title to goods, a sale, pledge or other disposition of the goods made by the agent when acting in the ordinary course of business of a mercantile agent is, subject to this Act, as valid as if the agent were expressly authorized by the owner of the goods to make the disposition, if the person taking under it acts in good faith and has not at the time thereof notice that the person making it has not authority to make it.

The Committee proposes that the OPPSA be amended to add a new Section 11(2.1) to provide as follows:

> "***11(2.1) For the purposes of subsection (2) and despite subsection 2(1) of the Factors Act, a person acting for an owner of goods as a mercantile agent, as defined in the Factors Act, has neither rights in such goods nor the power to transfer rights in them to a secured party, unless the owner of the goods has expressly authorized such person in writing to grant a security interest in the goods; and in the absence of such express written authorization, no security interest purportedly granted by that person in the owner's goods shall attach to them ."***

This amendment has the benefit of protecting the owner of the goods from the risk that the mercantile agent could grant a security interest in them to a third party without the owner's consent while preserving the ability of the consignee to deal with the goods by way of other dispositions of goods that do not give rise to security interests under the PPSA (such as sales).

Conclusion

The OBA appreciates the opportunity to make this submission on a proposed amendment to the OPPSA and would be pleased to provide further assistance to the Ministry in addressing the issue.

APPENDIX A

LIST OF PPSL COMMITTEE MEMBERS[13]

1. MICHAEL E. BURKE (CHAIR), Blake, Cassels & Graydon LLP
2. JASON ARBUCK, Cassels Brock & Blackwell LLP
3. JENNIFER E. BABE, Miller Thomson LLP
4. IAN BINNIE, Blake, Cassels & Graydon LLP
5. HARVEY CHAITON, Chaitons LLP
6. PAULA COOK, BMO Financial Group
7. DAVID L. DENOMME, BMO Financial Group
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9. PROFESSOR TONY DUGGAN, Faculty of Law, University of Toronto
10. ERIC B. FRIEDMAN, McMillan LLP
11. PROFESSOR BENJAMIN GEVA, Osgoode Hall Law School, York University
12. JARED GROSSMAN, Honda Canada
13. HINA LATIF, Mercedes-Benz Financial Services Canada
14. JOHN LAVIGNE, TD Bank Group
15. ANDREW McFARLANE, DLA Piper Canada
16. PROFESSOR RICHARD H. McLAREN, Faculty of Law, The University of Western Ontario
17. DAVID REYNOLDS, Miller Thomson LLP
18. ROBERT SCAVONE
19. HANK WHITE, Thomson Reuters
20. HENRY J.P. WIERCINSKI, Thornton Grout Finnigan LLP
21. SIMON WILLIAMS, Torys LLP

[13] This list is current as of the date of this submission.