

Collateral Matters

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Proposed Changes to the *Personal Property Security Act*

By Aaron Collins and Jesse Rosensweet*

Introduction

Ontario's "Open for Business Act" ("Bill 68") passed first reading on May 17, 2010. Bill 68 contains some changes to several sections of the *Personal Property Security Act* (Ontario) (the "PPSA"). These changes include: (i) narrowing the definition of a purchase-money security interest ("PMSI") to exclude sale-leaseback transactions; (ii) extending the length of time a creditor has to register a PMSI from 10 to 15 days; (iii) providing that the description of collateral on a financing statement or financing change statement will limit the scope of a check-box classification; and (iv) providing for additional situations in which a debtor can demand a financing change statement from a creditor to remove or limit collateral classification. This article will give a brief overview of the changes proposed in Bill 68.

The Definition of PMSI

Generally speaking, PMSIs provide a mechanism for a secured party, who finances all or part of an acquisition of goods or supplies goods on credit, to obtain priority ranking ahead of secured creditors with prior registrations under the PPSA. The intent behind PMSIs is to leave the debtor free to choose a new financier when purchasing or leasing new equipment or goods, based on the theory that such transactions are actually adding new items to a debtor's total pool of assets.¹ Transactions that qualify as "sale-leaseback" arrangements do not actually increase a debtor's asset pool and were therefore historically excluded from qualifying for treatment as a PMSI.²

However, the definition of a PMSI in the PPSA was amended by the *Securities Transfer Act, 2006* (the "STA"). The intention was to broaden the definition of a PMSI to include the interest of a lessor of goods, if the term of the lease was more than one year. The amendments in the STA suffered from a drafting error which omitted the text specifically excluding sale-leaseback arrangements from the definition of PMSI in the PPSA.³ The proposed changes to the definition of PMSI in Bill 68 would reinstate the previously omitted clause: "... but does not include a transaction of sale by and lease back to the seller." Given the well-recognized fact that the amendment by the STA was simply a legislative error, this change likely does not alter the law, but, nonetheless, the clarity is welcomed.

More Time to Register

The next change in Bill 68 will, if the bill is passed into law, extend the period available to a creditor to perfect a PMSI by registration from 10 to 15 days. Should Bill 68 receive Royal Assent, the following provisions of the PPSA will be affected:

- (a) Subsection 20(3)(a) will provide that, for collateral which is not an intangible, a PMSI must be perfected by registration before or within 15 days after the debtor obtains possession of the collateral; and

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- (b) Subsection 20(3)(b) will provide that, for collateral that is an intangible, a PMSI must be perfected by registration before or within 15 days after the attachment of the security interest in the intangible.

Corresponding changes to sections 33 and 35 of the PPSA are also proposed in Bill 68 to ensure that creditors who have perfected a PMSI within 15 days will have priority over other security interests. These changes will bring the time for perfecting a PMSI in Ontario into line with the other provinces in Canada.

Description Will Limit Collateral Secured

The proposed change to section 46 of the PPSA is likely to have the greatest effect on restoring certainty to the priority scheme set out in the PPSA. A 2007 amendment to the PPSA⁴ removed the prior subsection 46(3), which stated that the general collateral description (line 12 on a financing statement) which limits the scope of the collateral would do just that: it would narrow the collateral classification indicated by the check box on line 10. This meant that, for example, a PPSA registration that checked only the “Inventory” box in line 10 but had general collateral description in line 12 that went on to limit the classification of “Inventory” to a specified line of goods would only perfect a security interest in that specific line.

As the PPSA currently reads, the general collateral description cannot be relied upon to limit the scope of perfection of a collateral classification check box. The general practice has become that a creditor seeking a security interest in collateral that fits within a classification in which other creditors have registered a security interest will require an estoppel letter or waiver letter from the prior secured party which indicates precisely the scope of that party’s security interest.⁵ This additional step adds to the complexity, time and cost required to complete financing transactions.

At the time of the prior amendment, there were plans by the Ministry of Government Services to modernize the Ontario financing statement and financing change statement forms by removing the check boxes altogether, bringing Ontario into line with other Canadian provinces and the United States regime under the *Uniform Commercial Code*. However, this plan was delayed to allow for updates to the Ontario registry computer systems. It has been said that section 46 was amended “prematurely.”⁶

If passed, Bill 68 will re-introduce language of the prior subsection 46(3) in subsection 46(2.1) to provide once again that the “general collateral description” on line 12 of PPSA financing statements narrows the scope of category boxes checked on line 10 in the collateral classification:

(2.1) 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.

Where a Debtor Can Demand Financing Change Statement

If Bill 68 becomes law, section 56 of the PPSA will also be amended to allow a debtor to require that the secured party file amend its PPSA registration in two additional situations.

The new proposed subsection 56(2.2) provides for the removal of collateral classifications from a financing statement. If a secured party has, by checking boxes on line 10 of a PPSA financing statement, erroneously indicated that its security interest is in a broader class of collateral than that supported by its security agreement, then the debtor can require a correction of such a financing statement. For example, if a secured party only has a security interest in “Accounts,” but has checked all collateral classifications in its PPSA financing statement, the debtor can require the secured party to amend that financing statement to indicate only “Accounts.”

A similar mechanism is extended by the proposed subsection 56(2.3) to cover instances where a secured party has not sufficiently limited its interest in an asset category by providing a general collateral description on line 12 of its PPSA financing statement. In conjunction with the proposed change to section 46, this would require a creditor to register a financing change statement narrowing the scope of collateral within a category.

The changes in this section are designed to enhance the protection of parties whose property has been inaccurately collateralized by a creditor. To provide some teeth to the proposed subsections 56(2.2) and (2.3), subsection 56(4) would be amended to provide a remedy of \$500 plus “any damages resulting from the failure” of a secured party to register a financing change statement within ten days of receiving a written demand from the debtor.

Conclusion

The changes proposed to the PPSA in Bill 68, while not revolutionary, should be welcome changes that will provide clarity to sections which were amended as a result of hastily-enacted previous legislation. As this article is being written, Bill 68 is moving through the Ontario Legislature, but it should be noted that it is an omnibus bill that will amend several statutes. Given this, there may be any number of changes before it receives Royal Assent.

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1 Richard H. McLaren, *The 2010 Annotated Ontario Personal Property Security Act* (Toronto: Carswell, 2009) at 286.

2 *Ibid.* at 286.

3 *Ibid.* at 19.

4 Enacted pursuant to the Ministry of Government Services *Consumer Protection and Service Modernization Act, 2006*, S.O. 2006, c.34.

5 McLaren, *supra* note 1 at 347.

6 *Ibid.* at 346.

Documentary Letters of Credit: Banks' Obligation to Payee May Involve Duty of Good Faith

By Deborah Holbrook

Documentary letters of credit are frequently used to facilitate domestic and international trade and commerce between arm's-length parties. The letters of credit are issued by banks at the request of a buyer of goods, who does not want to pay for the goods prior to receiving them, to a seller of goods, who requires assurance that it will be paid promptly upon the delivery of the goods. In this way, the issuing bank acts as a trusted intermediary between the contracting parties and is charged with the responsibility of holding the purchase money in a form of escrow until the seller has presented the bank with the documents (usually documents of title and/or bills of lading, which evidence the delivery and acceptance of the goods in question) stipulated under the terms of the letter of credit.

It is a longstanding and fundamental principle of documentary letters of credit that an issuing bank is not required to look behind the documentation presented to determine its accuracy or legitimacy, but is simply required to honour the terms of the letter of credit, which terms are to be strictly construed.

Notwithstanding these principles of 'autonomy' and 'strict compliance,' the Ontario Court of Appeal has ruled in a recent case that an issuing bank also has an implied contractual duty of good faith, not to act in a way that defeats the purpose of the contract and, where a bank has breached this duty of good faith, it may be disentitled from relying on the defence of strict compliance even in circumstances where the conditions of the letter credit were not met.

The Facts

In *Nareerux Import Co. Ltd. v. Canadian Imperial Bank of Commerce*,¹ Douglas R. Robertson International Inc. ("**Robertson**") contracted with Thai Fisheries Co. Ltd. (the predecessor of Nareerux Import Co. Ltd., "**Thai Fisheries**") to purchase large quantities of Thai shrimp, which Robertson would then sell to Sam's Club, a division of Wal-Mart Stores Inc. To facilitate the sale and to bridge the time between when it would have to pay Thai Fisheries and when it would receive payment from Sam's Club, Robertson arranged for a line of credit with the Canadian Imperial Bank of Commerce ("**CIBC**") for more than \$20 million and arranged for CIBC to issue letters of credit to Thai Fisheries to secure payment for each shipment of shrimp received.

In 1993, CIBC issued two letters of credit, the terms of which provided that payment would be made by CIBC to Thai Fisheries upon CIBC receiving documentary confirmation that the shrimp had passed inspection by the United States Food and Drug Administration. Upon Robertson's receipt of payment from Sam's Club, Robertson would apply the funds to its line of credit.

Although this initial arrangement worked to the satisfaction of both Robertson and Thai Fisheries, CIBC was uncomfortable with its level of exposure between the time it made payment to Thai Fisheries and received payment from Robertson. CIBC attempted to address the issue by amending the terms of the letters of credit. After some negotiations between the parties, it was agreed that the letters of credit would not be payable to Thai Fisheries until CIBC had received a purchase order and delivery receipts from Sam's Club. This constituted a rather unusual arrangement since it resulted in Thai Fisheries no longer having control over the fulfillment of the conditions for payment.

The relationship between Robertson and Thai Fisheries began to break down in the fall of 1994, when Robertson stopped delivering the purchase orders and delivery receipts to CIBC, which resulted in Thai Fisheries not receiving payment for its shipments of shrimp. With CIBC's knowledge, Robertson not only continued to sell shrimp to Sam's Club without remitting the purchase orders and delivery receipts, but also sold shrimp to various third parties, in each case using the proceeds of the sales to pay down its line of credit with CIBC. The court found that CIBC was fully aware that this was taking place and that CIBC, in fact, collaborated with Robertson in this way to ensure it was paid the money it was owed by Robertson. By February 1995, Thai Fisheries had delivered approximately \$40 million worth of shrimp to Robertson and received payments of approximately \$29.5 million.

In October 1996, after Robertson had been fully paid its line of credit, CIBC wrote to Thai Fisheries advising that the letters of credit had expired because conditions for payment would not be met. Thai Fisheries replied with the lawsuit at hand.

The Decision of the Trial Judge

The trial judge found that, implied in CIBC's contractual relationship with Thai Fisheries, there was a duty of good faith and that CIBC breached this duty when it chose to act as a lender seeking satisfaction of what it was owed, rather than as an independent third party, holding money on behalf of Thai Fisheries pursuant to the arrangements contemplated by the letters of credit. The trial judge found that, to hold otherwise, would encourage lenders to prioritize their own interest of being repaid over the interests of the contracting parties, and this would defeat the very purpose of issuing letters of credit since letters of credit would no longer offer any kind of security of payment to third party payees.

The trial judge ruled in favour of Thai Fisheries, awarding it damages in the amount of \$10,381,035, representing the total amount owed to Thai Fisheries by Robertson for unpaid shrimp. CIBC appealed to the Ontario Court of Appeal.

The Decision of the Ontario Court of Appeal

CIBC argued that it was justified in not making payments on the letters of credit on the grounds that the conditions for payment, strictly construed, had not been met. In other words, it was a pre-condition of payment that CIBC receive the receipts from Sam's Club and, since no receipts were provided to CIBC by Robertson, CIBC had no obligation to make the payments.

The Ontario Court of Appeal held that CIBC was disentitled from relying on this defence of strict compliance in part because "it knowingly contributed to, or acquiesced in, the circumstances that undermined the prospect of strict compliance" and because it collaborated with Robertson to ensure that the proceeds received by Robertson for the sale of the shrimp were used to reduce its line of credit with CIBC.² In the Court's view,

[w]hether this conduct is characterized as a direct breach of the principle of autonomy underpinning letter of credit transactions or as a breach of CIBC's implied duty of good faith not to act in a fashion meant to defeat or eviscerate the purpose of the Letters of Credit, matters little, in my view. On either scenario – both of which were justifiably found by the trial judge to exist on the facts – CIBC, as issuer of the Letters of Credit, is precluded from raising the defence of non-compliance. Equity will not permit it to do so.³

In fleshing out its reasons, the Court addressed the principles of autonomy and good faith insofar as they relate to documentary letters of credit.

A. AUTONOMY

Justice Blair, speaking for the Ontario Court of Appeal, explained that letters of credit involve three separate and distinct agreements. First is the underlying contract between the buyer and seller. Second is the contract between the buyer and the issuing bank, and third is the contract between the bank and the seller or payee of the letter of credit. Each contract must be considered in isolation and must be governed according to its own terms. The obligation of the issuing bank to pay the beneficiary of a letter of credit is a standalone obligation that cannot be mitigated by extraneous factors. Specifically, the "obligations must be carried out irrespective of any dispute between the buyer and seller or between the bank and customer."⁴

B. DUTY OF GOOD FAITH

The Court confirmed that, while Canadian case law has not yet confirmed the existence of a stand-alone duty of good faith in the performance of a contract that is independent from the terms of the contract, it does confirm that there is “an implied duty of good faith not to act in a way that defeats or eviscerates the very purpose and objective of the agreement.”⁵ According to the Court,

Contracts in which performance is dependent upon the exercise of discretion on the part of one of the parties are contracts that are particularly characterized by the implied duty of good faith performance. In such circumstances, the discretion must be exercised reasonably and in good faith. Breach of a duty of good faith in the performance of a contract may be found where there is “evidence that some sort of bad motive – such as self-interest, ill will or a dishonest purpose – underlay a decision.”⁶

C. DEFENCE OF STRICT COMPLIANCE

The Court reviewed the history and case law surrounding the defence of strict compliance and held that, while the circumstances of this case have never been specifically addressed by a court, it had no difficulty applying the themes from the jurisprudence to the facts of this case:

Those themes are rooted in the failure to comply with the principles of autonomy and independence, buttressed by principles of equity and fairness, including the U.S. duty of good faith... The inappropriate character of the issuing bank’s conduct is the same: it places its interest as lender ahead of its duty as contracting party under the letters of credit, thereby interfering with the guiding principle of autonomy and independence, as well as the contractual duty of good faith.⁷

In the end, the Court concluded that the collusion between Robertson and CIBC both completely nullified the principle of autonomy and the independent role required of an issuing bank under a letter of credit and violated CIBC’s implied duty of good faith performance and that, as result, CIBC was disentitled from relying on the defence of strict construction. The Court dismissed CIBC’s appeal and upheld the trial judge’s award of damages to Thai Fisheries.

Conclusion

The decision in *Nareerux Import Co.* is important for banks issuing documentary letters of credit. While the narrow application is that issuing banks must act in good faith in circumstances where performance of the contract (i.e. presentation of the requisite documents) is outside the control of the payee (which circumstances are rather unusual), the broader application is that principles of fairness and equity apply to the individual contracts that underlie letters of credit and that, depending on the circumstances, these principles may act to defeat the bank’s defence of strict compliance.

1 *Nareerux Import Co. Ltd. v. Canadian Imperial Bank of Commerce*, 2009 ONCA 764 (CanLII)

2 *Ibid.* at par. 44.

3 *Ibid.*

4 *Ibid.* at par. 54.

5 *Ibid.* at par. 69.

6 *Ibid.* at pars. 71-72.

7 *Ibid.* at par. 67.

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