Critical distinctions in equipment leasing & financing between the U.S. & Canada

November 10, 2020

Introduction

When equipment financiers want to lend into the Canadian marketplace, their business units and legal teams need to appreciate that, while personal security regimes north of the border have significant similarities to those in the United States, there are some notable differences to keep in mind.

This primer provides an overview of the key legal rules applicable to the equipment financing and leasing businesses in Canada and in the U.S. Firstly, it is important to note that Canada is divided into nine common law jurisdictions and one civil law jurisdiction - Québec.

All common law jurisdictions have a *Personal Property Security Act* (the PPSA, collectively the PPSAs), modelled on the *Uniform Commercial Code* (the UCC) and more specifically on Article 9 of the UCC. Unless otherwise specified, references to the PPSA in this article are to the PPSA applicable in Ontario (the Ontario PPSA). Any differences from the other PPSAs would be specified.

Québec, a civil law jurisdiction, has adopted the Civil Code of Québec (the CCQ), which was modelled on France's *Napoleonic Code*.

While the provisions in the PPSAs and CCQ we will be discussing herein apply to both "true leases" under Article 2A of the UCC, and leases intended as security under Article 9 of the UCC, when referring to UCC leases hereunder, and in an effort to avoid confusion, we will focus exclusively on leases intended as security.

Conflicts of laws

a. Canadian common law jurisdictions and the U.S.

The "conflicts of law rules," which exist in each of the PPSAs, Article 9 of the UCC and the CCQ, all seek to answer the following questions: under which laws should a security interest or title retention be taken in order to be (i) valid (ii) enforceable and (iii) effective (in Québec, opposable) against third parties?

The conflicts of law rules vary depending on the type of right being secured and the asset class subject to the security and/or the retention of title.

At least two conflicts of law rules will almost certainly apply:

1. one respecting the specific property being financed (either "tangible personal property" or "cross-border collateral"), and
2. one for the proceeds thereof.

Under the PPSAs, the validity and perfection of security interests in tangible personal property are typically governed by the law of the jurisdiction where the charged property is located at the time the security interest attaches. The validity and perfection of a security interest in intangibles (proceeds) are governed by the law of the jurisdiction where the debtor is located at the time the security interest attaches. In all Canadian common law jurisdictions, a debtor is deemed to be domiciled in the jurisdiction where its registered office or head office is located.

In the U.S., pursuant to Section 301 of Article 9 of the UCC, the local law of the jurisdiction in which the debtor is situated typically governs perfection, the effect of perfection or nonperfection of leases intended as security. Pursuant to Section 307 of Article 9 of the UCC, when the debtor is a corporation, it is deemed to be situated in the jurisdiction where the place of business is located (if it only has one place of business) or at its chief executive office (if it has more than one place of business).

b. Québec

In Québec, there are two types of leases:

1. a *lease* is a two-party contract by which the lessor leases a movable property to a lessee in return for rent; or
2. a *leasing* is a three-party contract by which a lessor purchases an item from a vendor at the request of the lessee and then puts it at the disposal of the lessee in exchange for rent.

Title retention rights created by leases in Québec are not classified as "security interests" under Québec law, but rather "real rights." Pursuant to article 3097 of the CCQ, real rights and their publication are governed by the law of the place where the property concerned is situated for movable/personal property. It is unclear where intangibles are located and safe practice is to deem them to be located either where the lessee has its head office and/or where the tangible property leased is located. In all cases, valid publication under Québec law must be made in the Register of Personal and Movable Real Rights (the Québec Registry).

Security interests versus title retention

a. PPSA, article 9 of the UCC

In Canadian common law jurisdictions and in the U.S., for any security interest or any lease intended as security to be valid and enforceable against a third party, it must be (i) “attached” (or, in the U.S., “created”) and (ii) perfected.

i) Attachment/creation: three conditions must be met for attachment to occur:

- Value must be given by the secured party to the debtor;
- The debtor must have rights in the collateral; and
- The debtor must sign a security agreement containing a sufficient description of the collateral to make it easy to be identified, or the secured party must have possession or control of the collateral.

ii) Perfection may be effected when the PPSA financing statement or the UCC-1 financing statement is registered at the applicable register. In Canadian common law provinces and in the U.S., perfection can also be effected without registration when (i) the debtor is either in possession of the collateral; or (ii) in “control” of the collateral.

In short, in most cases, to perfect a security interest, a financing statement must be registered at the Provincial/Territorial PPSA registry (in Canadian common law jurisdictions) or at applicable local or State UCC registries (in the U.S.).

Moreover, each of the PPSAs and Article 9 of the UCC allows for the lessor to obtain a purchase money security interest (a PMSI) against the items leased and their proceeds, the extent of which will be discussed further below.

Section 1 (c) of the Ontario PPSA defines a PMSI as:

(a) a security interest taken or reserved in collateral, other than investment property, to secure payment of all or part of its price,

(b) a security interest taken in collateral, other than investment property, by a person who gives value for the purpose of enabling the lessee to acquire rights in or to the collateral, to the extent that the value is applied to acquire the rights, or

(c) the interest of a lessor of goods under a lease for a term of more than one year**.**

The effects derived from a PMSI should not be underestimated, because it grants the lessor a first priority lien (subject to only a limited list of super-priorities) over the items being leased. However, the manner of perfecting a PMSI depends on what type of property is being leased, as seen from the lease of the lessee:

- A PMSI *in tangible collateral, other than inventory*, has priority if perfection is effected before or within **fifteen (15) days after the lessee obtained possession of the collateral** (subsections 20 (3) (a) and 33 (2) of the Ontario PPSA) or within **twenty (20) days** in the United States (subsection 324 a) of Article 9 of the UCC).
- A PMSI in *inventory* has priority over any other security interest in the same collateral given by the same lessee, if:

i) In Canadian common law provinces, the PMSI is perfected (registered) at the time the lessee obtained possession of the inventory OR a third party, at the request of the lessee, obtained possession of the inventory (subsection 33 (1) of the Ontario PPSA and subsection 324 (b) of Article 9 of the UCC).

ii) A written notice informing of the taking of a PMSI in favour of the lessor over the collateral described by item or type is sent to all secured creditors who have registered at the applicable registry security interests which charge collateral that would include the leased items before the lessee receives possession of the inventory (subsections 20 (3) (a) and 33 (2) of the Ontario PPSA and subsection 324 (b) of Article 9 of the UCC) (the "PMSI Notice").

In all cases, it is possible to pre-filethe PMSI even before the applicable lease schedule is signed.

Both the PPSA and Article 9 of the UCC allow for the entering into and one-time registration of a master lease over any personal property leases by the lessor to the lessee from time to time, through the mechanisms of a "rolling PMSI."

b. Québec

As mentioned above, in Québec, there are both leases and leasings. In both cases, a title retention clause must be inserted into the agreement between the parties for such right to be valid and such right should be governed by Québec law.

For a leasing to be valid and enforceable in Québec, two other conditions must be satisfied:

1. leasing may only be entered into for business purposes (article 1842 CCQ); and
2. the lessor must disclose the leasing agreement in the deed of purchase (article 1843 CCQ) - that is, the lessor must advise the vendor that it is purchasing the unit in order to lease it to the lessee.

When the two aforementioned conditions have been met, the vendor of the property to be leased is, at law, directly bound to the lessee by legal and conventional warranties inherent in the contract of sale (article 1845 CCQ). This statutory recognition of "hell or high water" provisions, which will be defined later, for leasings often makes it a preferable vehicle for financiers, even though such provisions are also generally upheld in the case of leases.

A validly registered "rights resulting from a lease" (lease) or "right of ownership of the lessor" (leasing), which is registered in the Québec Registry, will provide the lessor with real rights that are actually more powerful than any PMSI over a financed item. This is because the property belongs to the lessor, and is not subject to super-priorities. Also, in most cases, the enforcement against such leased property is simplified.

A master lease/leasing is also available in Québec, and is subject to a one-time global registration. However, pursuant to article 2961.1 CCQ, such registration must be in respect of a "universality of property of the same kind"; and thus, counsel should be sought to properly describe the items leased in the underlying agreement in order to ensure its validity.

Unfortunately, the CCQ does not specify that the “rights resulting from a lease” (lease) or the “rights of ownership of the lessor” (leasing) extend to the proceeds of the property leased, as is the case in the PPSA and in Article 9 of the UCC. The result is that the only way to properly secure proceeds of sale/expropriation relating to the leased items is for the lessor to take a hypothec (in Québec) in such proceeds, subject to the comments below.

In Québec, the creation of a valid hypothec over the specific property is quite similar to the process of creation of a security interest over same, with certain differences. The similarities are:

1. the exact name of the hypothecary creditor and its address (typically the address of the applicable branch/office if it is a bank);
2. the exact name of the lessee and its address;
3. a full description of the collateral to be charged;
4. the term for which the hypothec should be registered (up to ten (10) years);
5. the date of signature of the hypothec; and
6. the location at which it was signed are all needed.

One important difference between a hypothec and a security interest is that a hypothec must be granted for a maximum amount (in Canadian dollars only – any other currency is invalid, rendering the hypothec invalid) and maximum interest rate. Both are notional amounts and need not reflect the actual amount of the debt outstanding. However, the hypothec cannot be enforced for more than what is actually owed to the hypothecary creditor by the lessee at any given time, no matter the amount of the hypothec and the amount of the interest rate.

Proceeds

a. PPSA, article 9 of the *UCC*

Subsections 25 (1) of the Ontario PPSA, 203 (f), 315 (a) (2) and 315 (d) of Article 9 of the UCC all clearly state that where collateral gives rise to any identifiable proceeds, the security interest also extends to any identifiable proceeds and remains continuously perfected as long as the registration remains effective notwithstanding its disposition. Hence, the attachment of the security interest to any identifiable proceeds is automatic and remains perfected if the security interest in the original collateral was perfected via a financing statement filed in the proper office for that collateral and its proceeds.

We see from this that “proceeds,” in all Canadian common law jurisdictions and in the U.S., must be identifiable in order to be covered by PMSI rules.When the proceeds are mixed/co-mingled with non-proceeds in the lessee’s bank account, in Canadian common law jurisdictions, the “lowest intermediate balance” rule applies and in the U.S., section 315(b) of Article 9 of the UCC calls for a method of tracing that is permitted under the general law of that jurisdiction, one of which is also the “lowest intermediate balance rule. The basic assumption in this approach is that the lessee, in making payments out of the account, is using non-proceeds money first, and only where the non-proceeds balance in the account reaches zero is the lessee assumed to be using proceeds funds.

Since proceeds are often deposited into a general bank account of the lessee and become commingled as a result, to obtain first priority over the proceeds, a lessor would need to take a first priority lien over the bank accounts of the lessee and/or obtain subordinations from prior ranking filers, something which is more difficult for lessors to obtain, especially when the lessee obtains general financing from another lender.

b. Québec

The same issues arise in Québec and are dealt with in a similar manner. However, co-mingling risk is amplified to some extent due to the debate as to whether or not proceeds are covered by the “rights resulting from a lease” (lease) or “rights of ownership of the lessor” (leasing).

Bankruptcy enforcement

In Canadian common law jurisdictions, pursuant to section 2 of the *Bankruptcy and Insolvency Act (Canada)* (R.S.C., 1985, c. B-3) (BIA), the trustee in bankruptcy of a lessee can claim rights in the goods. However, this is not the case in Québec. Due to the fact that a leasing/master leasing agreements is not deemed to be a “security interest” under Section 2 of theBIA, the trustee in bankruptcy of a lessee cannot claim any rights in the goods, hence, the lessor can immediately seize or sue to claim its leased items back.

A lessor under a lease intended as security is a secured party that does not have any ownership interest in the collateral, but a security interest instead. In addition, since the debtor has property rights in the collateral itself, it can use, sell or lease it pursuant to section 363 of Article 9 of the UCC. Therefore, a bankruptcy trustee under the U.S. Bankruptcy Code (Bankruptcy Code), in a lease intended as security, may in certain circumstances (such as fraudulent transfers or preferences), set aside the transactions and claw back the transferred property or funds into the bankruptcy estate.

“Hell or high water ” provisions

“Hell or high water” provisions make all liabilities for warranties relating to the items sold the sole responsibility of the vendor/manufacturer, and absolutely and unconditionally oblige the buyer to pay the lessor the rents on their due dates in all circumstances.

In Canadian common law jurisdictions and in the U.S., these “hell or high water” provisions are enforceable and are typically upheld by courts.

In Québec, under the CCQ, “hell or high water” provisions are statutorily protected only under leasing contracts. For leases, while there is no statutory protection, courts typically apply these.

Conclusion

The process of taking security and registration differs for aircraft, vessels and trains, which are governed by specific federal laws in Canada and the U.S. (and in the case of aircraft, international conventions as well), which are beyond the scope of this discussion.

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