

Cassels

Lessons Learned - Lesson Five: Insolvency & Leasing - True Lease vs. Finance Lease Remains an Important Distinction

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Cassels developed this **Lessons Learned** series based on our experience with priority disputes between secured creditors and the realization that many secured parties make fundamental errors of law that cause them to lose priority in their collateral. Each lesson in the series will outline a basic mistake and the lesson to be learned...

Lesson Five: Insolvency & Leasing – True Lease vs. Finance Lease Remains an Important Distinction

Introduction

In Lesson 4 we discussed that in the common law provinces, all leases for a term of more than one year had to be registered in order to perfect the secured creditor's/lessor's interest in the asset being financed regardless of whether it was a true or finance lease.

Despite there being no distinction of a true or finance lease for purposes of the requirement of registration under the Ontario *Personal Property Security Act* (PPSA), there is an important difference in cases of insolvency or default. This distinction matters in two different circumstances:

- When the secured creditor is selling the asset subject to the lease under Part V of the PPSA.
- In cases where the debtor files for protection under either the *Companies' Creditors Arrangement Act* (CCAA) or the Bankruptcy and *Insolvency Act* (BIA).

Default Remedies

Part V of the PPSA deals with rights and remedies of a secured creditor upon default. However, it is important to note that Part V of the PPSA only applies to finance leases, not to true leases.

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Application

57.1 Unless otherwise provided in this Part, this Part applies to a security interest only if it secures payment or performance of an obligation. 2006, c. 34, Sched. E, s. 19.

Case law has distinguished true leases from finance leases on the basis that a true lease does not secure payment or performance of an obligation.

The advantages of the non-application of Part V of the PPSA to true leases are as follows:

- There is no requirement to send a notice to other parties who may have an interest in the assets subject to the lease before selling the assets.
- There is no restriction as to any time period that the secured party needs to wait before selling the assets to a third party.
- If the secured party/lessor desires to foreclose on the asset, it can do so without any restrictions and continue to bring a claim for damages against the debtor.
- The secured party need not account for any surplus on the amount owed under the lease unless required by contract.

Bankruptcy / Restructuring

Section 65.1(4)(a) of the BIA and section 11.01(a) of the CCAA provide that, notwithstanding the commencement of the restructuring proceeding, a party may require immediate payment for the continued use of leased property after the BIA or CCAA filing.

However, the Courts have interpreted this provision narrowly to apply only where the lease in question is a true lease. This approach has been affirmed in a number of cases, including recently in the British Columbia Court of Appeal decision *Integrus Credit Union v Mercedes-Benz Financial Services Canada Corporation*.¹ The Courts have also applied a more stringent test for determining whether a lease is a true lease or a finance lease in the insolvency context than has been applied in other contexts, such as accounting or tax treatment.

In addition, in certain restructuring or receivership cases, the Courts have held that true lessors (or more specifically their collateral) are not responsible for sharing in the costs of the proceeding. However, the Court's approach on this issue remains mixed.

Common Traps

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The fact that a lease is a 'true' lease and is not subject to Part V of the PPSA does not mean that it need not be registered under the PPSA. As noted in Lesson 4, all leases need be registered if greater than one year, regardless of whether they are true or finance leases. The application of Part V is separate and distinct from the requirement to register.

One secured creditor in a recent insolvency believed that since Part V did not apply to a true lease, the entirety of the PPSA did not apply to the lease and there was no obligation to perfect a security interest in the leased goods. This belief was wrong and the secured creditor was unperfected, resulting in a loss.

Part V of the PPSA deals only with remedies on default of a secured transaction, not with whether the PPSA applies generally. Lessors and other creditors are encouraged to consult the PPSA or seek legal advice to determine whether the PPSA applies to a specific transaction.

Lesson Learned

True lease vs. finance lease remains an important issue with respect to a creditor's remedies on default or insolvency, but generally does not determine whether the PPSA registration requirements apply to a specific transaction.

¹ *Integris Credit Union v Mercedes-Benz Financial Services Canada Corporation*, 2016 BCCA 231, at para. 45.