Dear Members:

In September, many of us gathered in Chicago for the Business Law Section’s Annual Meeting. This meeting represented the Section’s second annual stand-alone Annual Meeting. The meeting featured a healthy attendance and a robust offering of CLE programming and substantive meetings of the committees and their subcommittees and task forces. Materials from CLE programs are available on the Business Law Section website. In addition, both ComFin and UCC thanked outgoing, and welcomed incoming, committee, subcommittee and task force leaders, including Kristen Adams, the new UCC Committee Chair.

The Committees are hard at work on CLE programming and substantive non-CLE meetings for the Business Law Section’s Spring 2016 Meeting. The 2016 Spring Meeting will be held on April 7-9, 2016 in Montréal, Canada, at the Fairmont Queen Elizabeth and the Hotel Bonaventure Montreal. Registration for this meeting may be completed on-line at the Section’s website. Of course, additional details will be forthcoming.

In addition to the UCC Spotlight by Carl Bjerre, this edition of the newsletter contains diverse articles written by leading scholars and practitioners of commercial law, including the final installment of the series LLCs article by Norman Powell. Of course, we also extend a hearty thanks to the entire CLN Editorial Board for putting this wonderful newsletter together.

Please email either of us if you have any ideas for either of the Committees or wish to participate in any project, subcommittee or leadership role. The Committees have a number of projects underway. Our subcommittees and task forces are very active and always welcome input. Please do not hesitate to volunteer!

We hope you enjoy this issue, and invite you to get involved in your committee(s).

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Mark Your Calendars

November 18, 2015 – 1:00 p.m. EST – Article 9 Security Interests: Navigating the Complexities in Drafting Legal Opinions (CLE Webinar). Click here for more information.

November 20-21, 2015 - ABA Business Law Section Fall Meeting - The Ritz-Carlton, Washington, DC  
Click here for more information.

November 24, 2015 – 1:00 p.m. EST – Financing In-Transit Inventory: Perfecting Security Interests and Resolving Priority Disputes (CLE

Joint Report from the Chairs
Editor's Note: This article is the third of three installments focusing on “series LLCs”. This third part focuses on the Bankruptcy Code implications for series LLCs. The first part (which was published in the Spring 2015 edition of the Commercial Law Newsletter) provided an introduction and overview of series LLCs. The second part (which was published in the Summer 2015 edition of the Commercial Law Newsletter) addressed the UCC consequences of series LLCs.

**Series LLCs and the Bankruptcy Code**

The interrelation between series LLCs and the Bankruptcy Code is still more uncertain. Because many series are not, or may not be, entities, they may be ineligible to become “debtors” under the Bankruptcy Code. Under the Bankruptcy Code, a debtor is “a person . . . concerning which a case . . . has been commenced.”1 Person, in turn, is defined to include individuals, partnerships, and corporations.2 It seems clear that a series of an LLC is not an individual, but whether it is a partnership or a corporation or both (for Bankruptcy Code purposes) is the more interesting question. The Bankruptcy Code does not define the term “partnership.”3 The Bankruptcy Code defines “corporation” such that it “(A) includes— (i) [an] association having a power or privilege that a private corporation, but not an individual or a partnership, possesses; (ii) [a] partnership association organized under a law that makes only the capital subscribed responsible for the debts of such association; (iii) [a] joint-stock company; (iv) [an] unincorporated company or association; or (v) [a] business trust; but (B) does not include [a] limited partnership.”4 The enumeration is illustrative, not exclusive or exhaustive. Since the advent of LLCs, most have become comfortable with the conclusion that they will be characterized as corporations for Bankruptcy Code purposes.5 Many series LLCs will fit the Bankruptcy Code’s definition of “corporation.” But it is far from certain whether any series of an LLC will fit the definition. Similarly, while there are arguments that internal shields will be respected in a bankruptcy proceeding, there is no basis on which to conclude that internal shields will be honored in the event a series of an LLC, or a series LLC itself, becomes a debtor in bankruptcy.

**Closing Opinions for Series**

Presumably, lenders to series will have many of the same concerns as lenders to more traditional borrowers. These include opinion issues specific to the borrower, such as status, power, and action opinions; opinion issues specific to the transaction, such as enforceability...
Group is a joint project of the UCC Article 1 and Article 2 Subcommittees together with the Implementation Task Force for the ABA Model Principles on Labor Trafficking and Child Labor. The mission of the new Working Group is to provide model contract clauses to interested businesses and trade associations. Ready-made, well drafted language will help move the principles from the realm of admirable aspirations to the workday world where they can make a difference. The legal issues are interesting and challenging because the default rules of UCC Articles 1 and 2 and the UN Convention on Contracts for the International Sale of Goods (CISG) are geared more toward assuring the quality of the goods (e.g., tightly stitched soccer balls or good quality apparel) and largely ignore the problems of a labor force that may be working in life-threatening conditions. A core group of leading lawyers has already signed up to tackle the issues and draft language, but more participants are welcome. This project is truly a working group, and we hope that participants will help with legal research, drafting memoranda, crafting contract language, and writing annotations. We anticipate roughly monthly conference calls as well as live meetings (with a phone-in option) at the Annual and Spring meetings of the Business Law Section. We hope that this work will use commercial law to make the world a better place, and perhaps even to save lives. If you are interested, please contact Professor David Snyder of American University at dsnyder@wcl.american.edu.

VIEW CURRENT REPORTS AND DEVELOPMENTS OF THE FOLLOWING COMMITTEES AND TASK FORCES:

COMFIN SUBCOMMITTEES AND TASK FORCES

- Subcommittee on Agricultural and Agri-Business Financing
- Subcommittee on Aircraft Financing
- Subcommittee on Creditors’ Rights
- Subcommittee on Cross-Border and Trade Financing
- Subcommittee on Intellectual Property Financing

Conclusion

Series are somewhat like, and yet different from, subsidiaries. They are typically established, not formed, by or pursuant to provisions in a governing instrument, and may or may not be separate entities. Thus, even the establishment of series implicates contract law. No jurisdiction currently requires a filing or other notice of series, though all require some form of filing or notice as a prerequisite to series’ internal liability shields. In some (e.g., Delaware), a general notice is sufficient. In others (e.g., Illinois), a specific notice filing with respect to each series is required. Internal liability shields may not be as widely upheld as some might assume. Where a series is intended to be a UCC RA9 debtor, complications can arise: where the series itself is the debtor, what and where to file to perfect security interests are unclear, as is the very applicability of UCC RA9. The manner in which series will be treated in bankruptcy (their own, if they’re found to be eligible debtors, or those of the related LLC) is simply unknown at this time. In common parlance, the words like “security” and “secured” connote safety from doubt, uncertainty, and risk. Under current law, lending to series is generally more fraught than secure.

Summary Points

- A series is typically an associated set of assets and liabilities.
- There may or may not be a public record of the existence of a series.
- A series might not have, or might lose, internal shields.
- Some series either aren’t entities or it’s unclear, and of course the answer may differ by context.
- Series cannot exist independently of the related series LLC.
- Series governance is flexible and may differ from that of the related series LLC.
- Series assets can be held in a number of different ways, some of which interface better with UCC RA9 than others.
- It is unknown whether series can file for protection under the Bankruptcy Code, and unclear how they will be treated in a bankruptcy of the related series LLC.

Norman M. Powell is a partner in the Delaware law firm of Young Conaway Stargatt & Taylor, LLP, where his practice includes formation of and service as Delaware counsel to corporations, limited liability companies, and statutory trusts, and the delivery of legal opinions relating to such entities, security interests, and other matters of Delaware law. He can be reached via email at npowell@ycst.com. This article first appeared in 46 UCC L.J. 95 (2015), and appears here through rights retained by the author. Certain of this article’s topics are further explored in Mr. Powell’s articles Series LLCs, the UCC, and the Bankruptcy Code—A Series of Unfortunate Events?, 41 UCC L.J. 103 (2008), and Opining on Limited Liability Company Series, PRAC. LAW., Aug. 2014, at 19. Mr. Powell is grateful to his colleague John J. Paschetto for his editorial and analytical assistance.
QUEBEC SECURITY ON DEPOSIT ACCOUNTS: AT THE FOREFRONT OF CHANGE

By: Kiriakoula Hatzikiriakos

On January 1st 2016, lenders taking security in Quebec deposit accounts will benefit from security perfection by control. If you are counsel to a US lender and have been involved in cross-border financing transactions involving a bank account located in the province of Quebec, this development is certainly good news. I recall a positive reaction from the attendees at American Bar Association’s International Commercial Law Subcommittee of the UCC Committee when I presented this topic at the Spring Business Law Section meeting last April.

The Quebec Bill 287 which contains this sweeping change to the Civil Code of Quebec’s8 (CCQ) secured transactions regime on deposit accounts and other “monetary claims” was tabled in December 2014 and assented to on April 21, 2015 (we will be referring to it throughout this article as the “New Bill”). In this regard, the New Bill’s objective is to facilitate the use of cash as collateral (allowing for perfection through control), particularly in derivative transactions where cash is predominantly used as collateral.9 The province of Quebec is not alone on this front. There have been discussions in other provinces, particularly in Ontario, on the same topic. In its 2012 and 2013 budgets, the Government of Ontario had announced its intention to change its personal property security regime. The Ontario Bar Association’s Personal Property Security Law Subcommittee10 made proposals to amend consistent with the approach taken under Article 9 of the Uniform Commercial Code (UCC). However, the Ontario government has yet to bring forward any amendments to the Personal Property Security Act11 (Ontario PPSA). Currently, in all Canadian provinces, a secured party can only perfect its security interest (hypothec in Quebec) in accounts (claims in Quebec) through filing its security in the applicable personal property security registry. Control is available as a method of perfection for investment property, but not for accounts12 or cash.

This article will outline the New Bill’s scope on security in deposit accounts13 through the use of a practical scenario. It will also give insight on what to anticipate in the near future when taking security in deposit accounts located in Quebec. This will certainly revive memories relating to discussions and debates prompted with the inception of the Model Deposit Account Control Agreement (DACA) and its use in market practice.14

Before I delve into the topic, recall the three-part series article entitled « An Attempt to Demystify Quebec Secured Transactions »15 (Quebec Article) in which I gave an overview of Quebec secured transactions law and, more particularly, the sections relating to taking security in receivables (claims). Under Quebec law, the conceptual and functional equivalent of a “security interest” is a “hypothec” and the concept of “perfection” is captured through the term “publication”.

The provisions of the New Bill taking effect as of January 1, 2016 will considerably amend the CCQ regarding the creation, publication, priority and conflict of law rules relating to hypotheis on “monetary claims”. It should be noted that a “claim” under the CCQ includes the concept of an “account” (i.e. right to payment of a monetary obligation).

The concept of “monetary claim” introduced by the New Bill is defined as any claim by the debtor to the lender under a loan agreement. As of January 1st, 2016, a creditor will be able to create and publish (perfect) a Quebec hypothec on a monetary claim through control, particularly in derivative transactions where cash is predominantly used as collateral. This will certainly revive memories relating to discussions and debates prompted with the inception of the Model Deposit Account Control Agreement (DACA) and its use in market practice.

This article will outline the New Bill’s scope on security in deposit accounts through the use of a practical scenario. It will also give insight on what to anticipate in the near future when taking security in deposit accounts located in Quebec. This will certainly revive memories relating to discussions and debates prompted with the inception of the Model Deposit Account Control Agreement (DACA) and its use in market practice.
control. Hence, publication through control will capture a broader category of collateral than “deposit accounts”, which is the case under Article 9 of the UCC.17

Creation and Publication: Current vs. New Regime

In this section, we will examine how a hypothec on a monetary claim is currently created and perfected and how this will change as of January 1, 2016 through the following fictitious pattern.

Let’s assume you represent a US financial institution (US Bank) lending to a US company with a Canadian subsidiary (Canadian Co.) located in the province of Quebec. Your client is extending revolving credit facilities on the value of the Canadian Co.’s account receivables which are deposited in a bank account (Bank Account) of a Canadian chartered bank (Canadian Bank) with its head office in Montreal, which bank has extended certain term credit facilities to the Canadian Co. Your current practice may be to send a “deposit account control agreement” (DACA) to the Canadian Bank. The US Bank may assume that a hypothec on a bank account can be created and perfected through “control”… which is not the case as of yet. In most cases, you are able to conclude a “blocked account agreement” with the Canadian Bank, which contains similar features to the DACA (absent the notion of perfection through control where the agreement is governed by Canadian laws).

Under the CCQ, a hypothec on a deposit account must be granted through a hypothec agreement (eg. bank customer grants hypothec to its bank) expressly granting a hypothec (“hereby hypothecate”) on such account with a hypothec amount and interest thereon.18 To ensure that this hypothec is enforceable against third parties, it must then be registered at the Quebec Register of Personal and Movable Real Rights (ie. personal property security registry).

As of January 1st 2016, a pledge of a bank account will be possible through the method of control. Let’s take a closer look at how this will occur in light of the new rules regarding the creation and publication of the security.

Creation and Publication of Security

Presently, control is not available as a method of publication of a hypothec on a deposit account. Perfection by control is available solely for “securities accounts”.19 As noted above, this is the state of the law in all Canadian provinces. The New Bill preserves filing as a way to publish a hypothec on a monetary claim, which is an important distinction from Article 9 of the UCC where control is the only method of perfection of a security interest in a deposit account. In addition to filing, the New Bill adds “control” as a new way to publish a hypothec on a monetary claim. Control will also afford higher “priority” vis-à-vis registered hypothecs.

The New Bill contemplates creation and publication of a hypothec with delivery (possessory security interest/pledge) on monetary claims through control via two possible scenarios: 20

1 – “bilateral” scenario (debtor-creditor relationship): a creditor obtains control of a monetary claim if the debtor has consented (verbally or in writing) that such claim secure the performance of any obligation (direct or indirect)21 to the creditor;22

2 – “triparty” scenario (debtor-creditor-third party relationship): a creditor obtains control of a monetary claim which (i) is transferred to a third party for the grantor (eg. amount held through an escrow agent) or (ii) relates to the credit balance of a financial account23 of the grantor maintained by a third party, if the creditor has entered into a control agreement with the third party and the grantor (third party agreeing to comply with the instructions of creditor without additional consent from grantor).24 In the second case (credit balance of a financial account), the creditor can also obtain control of the monetary claim relating to the credit balance if it becomes the account holder.25
How will this apply in the fictitious fact pattern? If the Canadian Co. consents that the funds in the Bank Account secure the performance of its obligations to the Canadian Bank, the latter has control over the Bank Account to the extent the Canadian Co. is a debtor to the Canadian Bank (which is the case given the indebtedness resulting from the term credit facilities). For the US Bank to obtain security through control on the Bank Account, the US Bank will have to enter into a control agreement with the Canadian Bank and the Canadian Co. This is certainly familiar territory for the US Bank who already has a model deposit account control agreement that it will present to Canadian Bank – later in the discussion we will take a closer look at the current practice in Quebec regarding deposit account control agreements and try to forecast the changes that will ensue once the New Bill comes into force. What rank will publication through “control” confer to the US Bank under Quebec law?

Priority Rules

The New Bill priority rules are similar to those found in Section 9-327 of the UCC, but have a broader application given the scope of the “monetary claim” concept. A hypothec on a monetary claim created and published through control ranks ahead of any other hypothec on the same claim (e.g. published through registration) from the time control is obtained. Between two hypothecs on the same monetary claim published via control agreements, the hypothecs rank among themselves according to when the third party (see triparty scenario above) agreed to comply with the creditor’s instructions.

A hypothec granted on a monetary claim that the grantor has against the creditor ranks ahead of all other hypothecs with delivery effected by control encumbering that claim. This rule modeled on Section 9-327 (3) of the UCC is broader in scope than Section 9-327. Section 9-327 applies to a deposit account maintained with a bank; under the CCQ, any hypothec on a monetary claim created and published through control in a bilateral scenario (see above) will have priority over any other hypothec.

Applying this rule to the fact pattern above, the Canadian Bank’s hypothec on the Bank Account will rank ahead of all other hypothecs effected by control on the same claim. As noted above, if the US Lender wants to obtain first-rank security on the Bank Account, it will request that a control agreement be entered into between the Canadian Co., the Canadian Bank and the US Lender. Pursuant to this agreement, the Canadian Bank will subordinate its first-ranking priority on the Bank Account to the US Lender and the Canadian Bank will agree to comply with the US Lender’s instructions with respect to the funds in the Bank Account without further consent by the Canadian Co.

The New Bill also introduces a rule similar to Section 9-327(4) of the UCC. It provides that if a monetary claim relates to the credit balance of a financial account and another creditor has obtained control of the claim by becoming the account holder, the latter’s hypothec shall rank ahead of the others.

Enforcement against monetary claims

A creditor with a hypothec on claims has a right to collect the revenues generated by the claims (together with the capital) while the hypothec is in effect, without having to exercise a hypothecary remedy (enforcement remedy).

In the case of a hypothec on a monetary claim, upon default, the remedies available to the secured party will depend on the type of hypothec-scenario, as outlined above. In a bilateral scenario, the creditor will be able to operate set-off between the sums it owes to the debtor (grantor of the hypothec on the monetary claim) and the sums owing by such debtor to the creditor (secured by the hypothec).

In a triparty scenario, the control agreement will set-out how the secured party can exercise its rights on the monetary claim. The agreement will also provide whether the debtor is authorized to make withdrawals and when the creditor can withdraw such authorization. No notification of registration formalities for the authorization withdrawal are necessary, as is the case for “claims” other than monetary claims.

Conflict of laws

In the current context, when requested, many Canadian financial institutions propose their form of “blocked account agreement” to the US lenders. These agreements are very similar to the DACA. However, given the current state of Canadian secured transactions laws on deposit accounts, the agreements do not typically provide that perfection is achieved through control. As of January 1st, this will change for agreements governed by Quebec law. The conflict of law rules relating to the creation, publication, priority and enforcement of hypothecs on deposit accounts under the New Bill were inspired by those found under Article 9 of the UCC.

Under the current Quebec conflict of law rules, security on a deposit account is considered security on a « claim » (claim that a customer has against the bank) and, as such, are governed by the conflict of laws relating to security on incorporeal (intangible) property. Under these rules, the law applicable to the security’s validity, publication (and its effects) is the debtor’s « domicile » (i.e. head office/registered office for a corporate body or residence for an individual). The same conflict of law rule applies to all Canadian provinces.
As noted, for deposit accounts, the New Bill\textsuperscript{30} conflict of law rules are very similar to those found under Section 9-304 of the UCC. In essence, the parties can choose the law that applies to the validity, publication and effects of security on a monetary claim. The law governing the validity,\textsuperscript{31} publication and its effects is the law designated to govern such issues provided in the agreement relating to the monetary claim (e.g. account agreement). If such law is not designated in the agreement, we would then look at the governing law of such agreement. Where no governing law is provided in the agreement, the applicable law would be:

- \textit{in the case of a claim relating to the credit balance of a financial account}, the law of the jurisdiction where the establishment expressly mentioned in the act governing the financial account as being the establishment where the account is maintained is located or, if no establishment is expressly mentioned in such an act, the law of the jurisdiction where the establishment identified in an account statement as the establishment serving the account holder’s account is located. If no law may be determined from the account statement, the applicable law is the law of the jurisdiction where the decision-making centre of the person maintaining the account is located;\textsuperscript{32}

- \textit{in the case of a claim relating to an amount of money transferred to secure the performance of an obligation towards the creditor (triparty scenario \textsuperscript{i}) above}, the law of the jurisdiction where the decision-making centre of the person to whom the amount of money was transferred (e.g. escrow agent) is located or, if the person is an individual person, the law of the jurisdiction where the person is domiciled.

In the case study outlined above, to the extent the Canadian Co. is located in Quebec and the Bank Account is maintained in Quebec, the US Bank and the Canadian Bank have the freedom of choosing the law that will apply to the validity and publication of the US Bank’s security on such bank account. A word of caution: given that other Canadian provinces have not yet implemented changes to their Personal Property Security Acts with respect to cash collateral, this choice of law would not be recognized in front of a Canadian court outside Quebec. A practical example: if the Canadian Co. is located (chief executive office) in Ontario, the Bank Account is maintained in an account of the Canadian Bank in Quebec and the US Lender finds itself in litigation proceedings facing an Ontario court, in applying the Ontario secured transactions conflict of laws rules, the validity and publication of the security in the Bank Account would be governed by the law of the debtor’s location (chief executive office). Hence, in this example, in addition to putting in place a control agreement (in compliance with Quebec law), a filing in the Ontario personal property security registry would be required to validly create and perfect the US Bank’s security in the Bank Account pursuant to the Ontario PPSA.

\textbf{Practical Considerations}

As noted earlier, in contrast to Article 9 of the UCC which grants automatic control to a bank over its customer’s deposit account, the New Bill requires “consent” of the customer for having its deposits secure the performance of its obligations to the creditor. Banks maintaining accounts in Quebec may therefore consider obtaining such consent at the outset in their account agreement with their customers.

It is also important to note that any agreement whereby control of a monetary claim is obtained prior to January 1, 2016 will be recognized. Practically, this means that an agreement (i.e. blocked account or deposit account control agreement) signed prior to that date will be validated to the extent it complies with the requirements of the New Bill. \textsuperscript{33}

Bearing in mind the January 1, 2016 entry into force of the New Bill, financial institutions with operations in Quebec will definitely be developing their model deposit account control agreements and putting in place the operational structure allowing them to deal with third party requests for security in their deposit accounts. As practice usually dictates, they will most probably want to use their forms when another financial institution wants control over one of their deposit accounts. This should not come as a surprise given the current market practices surrounding blocked account agreements by Canadian financial institutions. Since Quebec will be the only Canadian province where “control” will perfect security on deposit accounts, such institutions will have to keep their “current” blocked account agreements (with no “control” language) for use in all Canadian provinces other than Quebec.

With respect to the issues that will require negotiations between the secured party and the depository institutions, we suspect that the following key provisions will give rise to discussions, as is the case with blocked account agreements: right of depository institution to set-off for chargebacks, returned cheques, deposit account fees, indemnity provisions in favour of the depository bank for losses sustained by it in connection with the account or further to complying with the secured party’s transfer instructions, delays upon which the depository bank must act further to instructions received from the secured party and delivery mechanism of copies of account statements to the secured party. These issues are not so foreign to negotiations involving account control agreements in the US market.\textsuperscript{34}

We understand that another important issue is the moment when control is actually achieved when a control agreement is executed.\textsuperscript{35} Under Section 9-104(a)(2) of the UCC, a secured party has control if “the debtor, secured party, and bank have agreed in an authenticated record that the bank will comply with instructions originated by the secured party directing disposition of the funds in the deposit account without further consent by the debtor”. The rule is similar under the New Bill. \textsuperscript{36} In control agreements, we do, however, typically see certain requirements that need to be satisfied before the depository bank has the obligation to comply with the
secured party’s instructions (e.g., proof of default of debtor by secured party, actual delivery of the initial instruction). It has been questioned whether such requirements may affect the existence of control as set out in Section 9-104 of the UCC. It is interesting to note that Official Comment 3 of this Section clearly states that “[a]n agreement to comply with the secured party’s instructions suffices for “control” of a deposit account… even if the bank’s agreement is subject to specified conditions e.g., that the secured party’s instructions are accompanied by a certification that the debtor is in default.” To avoid any debate on the issue of whether control has been achieved, it has been recommended to request an opinion from borrower’s counsel on perfection through control of the deposit account as of the closing date. 37 We anticipate that this type of opinion may also become practice with regards to Quebec deposit account control agreements. Given the similarities between the New Bill’s provisions on security on deposit accounts and those found under Article 9 of the UCC, the US lenders’ experience and market practices can certainly be useful for the financial institutions maintaining deposit accounts in Quebec.

The New Bill provisions on security on monetary claims represent a significant step towards greater harmonization with Article 9 of the UCC rules on deposit accounts. Hopefully, the other Canadian provinces will follow the same path in the foreseeable future.

Kiriakoula Hatzikiariakos, LL.M is Senior Legal Counsel and Manager of the Commercial Section of the Legal Affairs team at the National Bank of Canada.

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FAST TRACK: A PRIMER ON NORTH AMERICAN RAIL TRANSACTIONS

By Jennifer Wasylyk

Freight rail activity in North America is steadily increasing and, based on industry reports, this increase is expected to continue into the foreseeable future. This increase in freight transportation by rail, combined with new tank car regulations in Canada and the United States and the aging and gradual failure of the current fleet of railcars, will result in an increase in the number of railcar financings and related transactions.

This article provides an overview of key legislative and other developments in Canada and the United States impacting railway companies and/or rail equipment. Although the recent legislative changes stem from several factors, the most significant motivation behind the new and amended legislation is the 2013 Lac Mégantic rail disaster.

In addition to the current regulatory environment affecting North American rail activity, this article will outline the procedures for taking a security interest over rail assets in Canada or the United States and cross-border considerations for rail transactions.

Lac Mégantic Derailment

On July 6, 2013, an unattended freight train carrying crude oil rolled down a hill and derailed in the center of Lac Mégantic, Quebec. The resulting fire and explosion killed 47 people, making the derailment the deadliest non-passenger train accident in Canadian history. The explosion, which had a blast radius of one kilometre or approximately 0.62 miles, destroyed more than 30 buildings in the downtown area. Almost all of the remaining buildings have been or are scheduled to be demolished as a result of petroleum contamination.

Important Developments

In response to the Lac Mégantic disaster, regulators in Canada and the United States have introduced changes to several pieces of legislation affecting North American rail activity. This section highlights the most important and widest-reaching legislative and other changes.

New Tank Car Regulations

1. The Canadian Transportation of Dangerous Goods Regulations (TC 117 Tank Cars)38 (the “TC 117 Regulations”) and the corresponding United States rule, Hazardous Materials: Enhanced Tank Car Standards and Operational Controls for High-Hazard Flammable Trains39 (the “DOT 117 Rule”) introduce specifications for a new class of tank cars and retrofit requirements for existing tank cars used to transport flammable liquids. Under the TC 117 Regulations and the DOT 117 Rule, existing tank cars used to transport flammable liquids, such as crude oil and ethanol, must be phased out between 2017 and 2025, depending on the type of tank car and flammable liquid being transported, with the regulations being applied to tank cars carrying crude oil first. Existing tank cars must be retrofitted or replaced by new tank cars to comply with the new standards, including thicker steel, a jacket with thermal protection and new bottom outlet requirements. Although Transport Canada and the United States Department of Transport worked together in an effort to harmonize the TC 117 Regulations and the DOT 117 Rule, there are some differences, namely:
Trains operating in the United States and carrying high-hazard flammable materials must use electronically controlled pneumatic brakes, a requirement that has received criticism from several industry experts.

The timeline for the retrofit of affected tank cars differs slightly.

Insurance/Accident Compensation

The Safe and Accountable Rail Act\(^4\) amends the insurance provisions of the Canada Transportation Act\(^5\) (the “CTA”), the primary rail legislation in Canada. The amendments introduce a new liability and compensation regime consistent with other modes of transport, such as marine tankers and oil pipelines. The amended CTA insurance provisions, which are based on the “polluter pays” principle, make railway companies and shippers responsible for the cost of accidents.

The amended Canadian insurance provisions have two prongs: (1) minimum liability insurance requirements and (2) the introduction of a shipper-funded compensation fund.

Freight railway operations in Canada must maintain minimum liability insurance coverage based on the type and volume of goods transported. Companies transporting minimum quantities of dangerous goods must carry $25 million of liability insurance whereas companies transporting large volumes of dangerous goods, such as crude oil, must carry $1 billion of liability insurance. Railway companies that do not maintain the applicable minimum liability insurance will be prohibited from operating and may be subject to a fine of up to $100,000.

In addition to the new minimum liability insurance requirements, Canada has also established a shipper-funded compensation fund, financed by levies on shippers, to cover the losses, damages, costs and expenses resulting from railway accidents involving crude oil or other designated goods that exceed the minimum liability insurance coverage. Shippers of crude oil and other designated goods must contribute $1.65 per tonne (or approximately $0.23 per barrel) of crude oil shipped on a federal railway to the fund.

The United States does not have equivalent legislation relating to minimum liability insurance or other forms of accident compensation. Liability insurance is at the discretion of the individual railway companies.

Insolvency – Jurisdictional Uncertainty in Canada

The CTA contains a narrow framework for insolvent railway companies, which is limited to a simplified arrangement scheme based on shareholder and secured creditor consent. Notwithstanding that many commentators have criticized the CTA’s insolvency framework, the jurisdiction of the CTA over the insolvency proceedings of railway companies has generally been accepted. However, a recent Quebec Superior Court ruling creates some uncertainty in this area of the law.

In Montréal, Maine & Atlantique Canada Co. (Arrangement relatif à),\(^2\) the creditors of Montreal, Main & Atlantic Canada Co., the railway company at the center of the Lac Mégantic disaster, sought protection under the Companies’ Creditors Arrangement Act (the “CCAA”), a restructuring act that applies to Canadian companies and companies doing business in Canada. The CCAA specifically carves out certain corporate entities, including railway companies, from its application and, accordingly, it has generally been accepted that the CCAA does not apply to an insolvent railway company. However, the Quebec Superior Court recognized that CTA does not provide rights to unsecured creditors, among other shortcomings, and applied the doctrine of inherent jurisdiction to hold that the CCAA applied. At the time of publication, this ruling has been appealed by Canadian Pacific.

Procedures for Taking Security over Rail Assets

Canada

Where railcars cross provincial or territorial borders or the US-Canada border into Canada, any related security interests are governed by the CTA. Once a document is deposited under CTA, no further deposit, registration or filing under any other law or statute respecting real or personal property is required and the deposited document is valid against all persons.

Section 104 of the CTA relates to general security granted by railway companies (i.e. the ability to deposit a document under section 104 depends on the nature of the debtor) and permits the deposit of a mortgage, hypothec or security agreement entered into by a railway company or a related assignment or amendment. Section 105 of the CTA, on the other hand, relates to security over rolling stock (i.e. the ability to deposit a document under section 105 depends on the nature of the collateral) and permits the deposit of a lease, sale, conditional sale or security agreement relating to rolling stock or any accessories thereto or a related assignment or amendment.
Section 105 allows for memoranda or summary filings, which can be advantageous if there is a desire to keep the underlying document (which may include confidential information or deal terms) private.

Where railcars have additions to them, such as racking or detachable assets, or where rail operations are intra-provincial or intra-territorial, it is common practice to make registrations under the CTA and the applicable Personal Property Security Act (or the Quebec equivalent).

United States

The Surface Transportation Board (the “STB”) maintains a recordation system for security interests in rolling stock which is similar to the Canadian system. STB filing procedures are substantially similar to deposits under section 105 of the CTA. A filing with the STB is effective against all persons for the purposes of US law.

Similar to Canadian practice, a filing under the Uniform Commercial Code may be appropriate where equipment is not engaged in interstate commerce (e.g., yards or factories).

Reciprocity

Although the STB recognizes security interests filed under the CTA as valid security interests in the United States, the CTA does not have equivalent reciprocity. Accordingly, where railcars will cross the Canada-US border into Canada, a filing under the CTA should be completed.

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UCC Spotlight

By Carl S. Bjerre

The purpose of this column is to identify some of the most disconcerting judicial decisions interpreting the Uniform Commercial Code or related commercial laws. The purpose of the column is not to be mean. It is not to get judges recalled, law clerks fired, or litigators disciplined for incompetence. Instead, it is to shine a spotlight on analytical errors, and thereby provide practitioners and judges with reason to disregard the decisions.

Guaranty Bank & Trust Co. v. Agrex, Inc.
2015 WL 24353232 (N.D. Miss. 2015)

This case involves a straightforward question about an account debtor’s rights against a secured party, but the court reached the wrong result by entangling itself in questions of priority.

Agrex, Inc., an agricultural trading company, had contracts requiring a partnership to make forward deliveries of soybeans and other commodities. The partnership failed, and Agrex and one of the partners, named Walker, agreed to proceed on the contracts with Walker himself being the obligor. Walker then obtained financing from Guaranty Bank & Trust Co., secured among other things by a security interest in the 2012 soybean crop that was under contract to Agrex. Walker thereafter fully performed on almost all of the contracts with Agrex but only partly performed on the 2012 soybean one. Agrex withheld payment for the undelivered soybeans, Walker defaulted on the payment to Guaranty, and Guaranty sued Agrex, asserting a right to the proceeds of its collateral.

The proper analysis would have been that Agrex has a defense against Walker that is also effective against Guaranty under UCC § 9-404(a)(1). The contract between Walker and Agrex creates an account; Agrex is an account debtor; and Guaranty is an assignee of the account as proceeds of its original collateral. See § 9-102(a)(2), (3) and cmt. 26. Walker’s material breach on the contract creates a defense to payment on Agrex’s part, which entitles Walker to withhold the corresponding payment amount. See also UCC § 2-717 (providing a self-help right for buyers to deduct damages from an unpaid purchase price). Of course Walker, not Guaranty, committed the breach, but Guaranty’s rights are limited by Walker’s. Section 9-404(a)(1) is thus an example of “derivative rights,” rather analogous to § 9-203(b)(2)’s rule about the debtor having rights in the collateral. (The analysis would differ if the underlying contract included a waiver of defenses
The court, however, purported to fend off § 9-404(a) by pointing to the irrelevant fact that Guaranty’s collateral was “not solely, nor primarily, [the] accounts” but also included the crops and perhaps other proceeds. This left the court feeling free to devote its attention to priority. Mississippi has enacted Article 9’s model provisions on production money security interests or “PrMSIs” (UCC §§ 9-103A and 9-324A), and the bank’s rights to the crops fit the definition. The bank had taken the right statutory steps to obtain super-priority in the crops, and such a super-priority even generally extends to proceeds in the form of accounts (so that PrMSIs mirror PMSIs in equipment rather than inventory in this respect).

The court failed to see that these priority rules were beside the point because the Agrex-versus-Guaranty dispute was about derivative rights—not “priority” at all. Without getting too metaphysical, it’s one thing to assert an interest in the debtor’s account (like Guaranty) but another and more powerful thing to be the source of the debtor’s account (like Agrex). Any contract, like this account, is an intertwined package of rights and liabilities, and Walker’s breach resulted in a limitation on Agrex’s liabilities with a corresponding limitation on Walker’s and Guaranty’s rights. Guaranty may well have had priority over anyone claiming through Walker, but Agrex wasn’t claiming through Walker: instead, Agrex was (rightly) preventing Walker from acquiring rights in the first place.

In a similarly mistaken line of reasoning, the court stressed Guaranty’s temporal precedence over Agrex. At the time Guaranty had established its security interest, wrote the court, the crops to be sold to Agrex did not yet exist and/or had not yet been identified and hence were “future goods” under Article 2. From this the court concluded that Agrex’s “interest in [the] crops for application of priority determination can only apply and pass when the crops exist and can be identified.” There are several errors here. For one thing, Agrex was not asserting an interest in Walker’s crops (any more than it was asserting an interest in Walker’s account, as discussed above). And most important, temporality in acquiring rights from Walker is beside the point under § 9-404(a)(1), with its focus on what rights Walker had in the first place.

Early in its opinion, the court had cited a non-UCC state supreme court case for the “long held maxim” that an assignee’s rights can rise no higher than those of the assignor. But the court failed to heed this maxim, and failed to see that its derivative rights reasoning is codified for disputes like this one in § 9-404(a)(1).

**American Home Assurance Co. v. Weaver Aggregate Transport, Inc.**
2015 WL 419227 (M.D. Fla.)

One of Article 9’s most basic principles is that perfection of a security interest protects the secured party against later-in-time lien creditors, of which a garnishing judgment creditor is a classic instance. But in this case the court tossed a monkey wrench from the common law of setoff into the Article 9 machinery and thereby failed to protect a bank’s perfected security interest in the deposit account that it maintained.

The Farmers and Mechanics Bank had a security interest in the deposit account that it maintained for Weaver Aggregate Transport, and as usual in such a transaction, the security interest was perfected by control under UCC §§ 9-314(a) and 9-104(a)(1). American Home Assurance subsequently obtained a judgment against Weaver and sought to garnish the deposit account. Weaver owed more on the bank loan than was in the deposit account, and the bank contested the garnishment in an attempt to protect its own rights. The court got off on the wrong foot by confusing security and setoff. (Early in the opinion the court writes that the bank “may request a right of setoff, provided it can show it has a perfected security interest” in the deposit account. And a moment later this confusion seems to flow in the opposite direction: the court concludes that the bank has a security interest in the deposit account, but only after taking care to note that “the[] circumstances” include the loan documents reserving to the bank a right of setoff.) In reality, while security and setoff can often coexist, they are independent devices with the latter being mostly a creature of common law.

Because the bank’s security interest in the deposit account was perfected before the garnishment process got under way, it should have been simple for the court to conclude that the bank had priority over the garnishing creditor under §§ 9-201(a) and 9-317(a)(2)(A). But the court wrote that “a perfected security interest does not necessarily entitle the bank to a setoff” (the court seems to have actually meant priority), and that, instead, the bank “must also show that it declared the loan in default and took affirmative steps thereafter to enforce its rights.” After a lengthy inquiry into

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Clause, but the contract between Walker and Agrex did not—in fact it expressly provided that “Buyer may, to the fullest extent permitted by law, exercise the right of set-off . . . against any amount otherwise due seller.”

"the[] circumstances" include the loan documents reserving to the bank a right of setoff.) In reality,

opposite direction: the court concludes that the bank has a security interest in the deposit account, but only after taking care to note that “the[] circumstances” include the loan documents reserving to the bank a right of setoff.) In reality, while security and setoff can often coexist, they are independent devices with the latter being mostly a creature of common law.

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whether the bank had in fact declared the loan to be in default, the court found that it had not and ruled in favor of the garnishing creditor.

In the context of setoff rather than Article 9, a requirement that the loan have been declared in default can make sense: after all, setoff is generally available only when the mutual debts are both due and payable. (On the other hand some jurisdictions permit setoff so long as the lender has the power to declare the default, regardless of whether the lender has actually exercised the power.) But Article 9 has no default requirement except where the lender is seeking a Part 6 remedy, such as foreclosure or, in the context of a deposit account, the application of the deposit account balance to the loan under § 9-607(a)(4) or (5). The Farmers and Mechanics Bank was seeking no such remedy here. Instead, the bank was only seeking the continued protection of its property rights for the purpose of eventual recovery – exactly what should have been afforded by the bank’s perfection.

The roots of the court’s confusion can be briefly traced. Before the 2001 revision of Article 9, the Eighth Circuit had issued an opinion permitting the garnishment of a deposit account encumbered by a perfected security interest, but simultaneously making clear the protective effect of the security interest. “Article 9 requires that [the garnishing creditor] take the remaining funds subject to [the bank’s] security interest,” wrote that court; the bank’s interest in the funds would “continue” and the bank had the possibility of recapture after default. Frierson v. United Farm Agency, Inc., 868 F.2d 302 (8th Cir. 1989). (This was a defensible result before the advent of Revised Article 9’s § 9-332(b), under which a transferee of funds from an encumbered deposit account now generally takes the funds free of the security interest.) See also Orice Fin. Servs., Inc. v. Kawacs, 83 Cal. Rptr. 3d 900 (2008) (applying this provision to a garnishing judgment creditor to whom funds were paid out.) But the Eighth Circuit’s reasoning became distorted by a couple of later Northern District of Illinois cases under Revised Article 9, which in turn were relied on here. The Illinois cases, while purporting to apply the same reasoning, sloppily paid no attention to the property rights of the perfected secured party. As a result, the garnishing creditors in the Illinois cases effectively wound up taking free of perfected security interests (even without § 9-332(b), which the courts ignored and which would not have applied on the facts anyway).

Our case carried a further error that may or may not have heightened the importance of the above Illinois cases. The court applied § 9-304’s choice-of-law rule for deposit account collateral by looking to the wrong documents, and wound up applying Illinois law (though the right documents may have pointed to Illinois law too – the opinion is not explicit on this point). Under § 9-304 the effect of perfection is determined by “the bank’s jurisdiction,” rather than by Article 9’s usual location-of-debtor rule, and under subsection (b)(1) a choice-of-law clause in the account agreement determines the bank’s jurisdiction. The court correctly referred to this statute but applied it to the choice-of-law clause in the “Loan Documents,” which did not include the account agreement but only the loan and security agreements and the promissory note. Without this error, the Illinois cases might have been left in the shadows where they belonged.

One additional and rather large blooper deserves attention. The security agreement in this case had a standard clause providing that after an event of default, the bank “shall have all the rights of a secured party.” From this clause (and here too following the lead of the Illinois cases), the court wrongly inferred a negative implication that the bank “only takes on the rights of a secured creditor under the U.C.C. after a default occurs” (emphasis added). In effect, the court misconstrued a routine confirmation of a secured party’s remedies as something like a provision for postponed attachment under § 9-203(a)! But provisions for postponed attachment are extremely unusual, of course, and there was no reason in this case to think that the parties intended anything of the kind. On the contrary, the whole point behind a lender’s taking of security is to protect the lender before it gets too late – so, usually, right away is best. And in general, perfection of the security interest should have provided exactly this type of ex ante protection, even against a judgment creditor wielding a writ of garnishment, and independently of default.

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Compiled by Commercial Law Newsletter Co-Editors Glen Strong, Christina Goebelsmann, Hilary Sledge-Sarnor, Harold Lee, Suhuyini Abdulai and Sidney Simms.

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2. The UCCLAW-L listserv is sponsored by West Group, publisher of the “UCC Reporting Service.” The listserv is an email discussion group focusing on the Uniform Commercial Code. To subscribe to the UCCLAW-L listserv, go to http://lists.washlaw.edu/mailman/listinfo/ucclaw-l


5. Gonzaga University’s new Commercial Law Center has a variety of links to useful sites and can be accessed at http://www.law.gonzaga.edu/Centers-Programs/commercial_law_center/default.asp

6. The International Association of Commercial Administrators (IACA) maintains links to state model administrative rules (MARS) and contact information for state level UCC administrators. This information can be accessed at http://www.iaca.org

7. The Uniform Law Commissioners maintains information regarding legislative reports and information regarding upcoming meetings, including the Joint Review Committee for Uniform Commercial Code Article 9. You can access this information at http://www.uniformlaws.org/Committee.aspx?title=Commercial Code Article 9


10. The Secretariat of Legal Affairs (SLA) develops, promotes, and implements the Inter-American Program for the Development of International Law. For more information, go to http://www.oas.org/DIL/

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14 The DACA was developed by the American Bar Association’s Task Force Model Deposit Account Control Agreement in 2006. It is available at <http://www.abanet.org/dch/committee.cfm?com=CL710060>.


16 Negotiable instruments and the taking of security therein is governed by other articles of the CCQ and federal legislation (Bills of Exchange Act, RSC 1985, c. B-4) cf. Section 9-312 of the UCC and Comment 3 of Section 9-104 (“Perfection by control is not available for bank accounts evidenced by an instrument (e.g., certain certificates of deposit), which by definition are ‘instruments’ and not ‘deposit accounts’”); for security and security entitlements, refer to the Act respecting the transfer of securities and establishment of security entitlements, CQLP c. T-11.002, as well as articles 2714.1 ff. and 3108.1 ff. of the CCQ for the creation, publication, priority and conflict of law rules in securities and security entitlements.

17 U.C.C. §§ 9-312, 9-314.


19 Art. 2713.3 and art. 2713.4 of art. 361 of New Bill; cf. U.C.C. § 9-104.

20 This allows for obligations of the debtor as a guarantor toward the creditor to be secured.

21 Control is not affected by the fact that the grantor retains the right to give instructions as regards the claim: art. 2713.7 of art. 361 of New Bill (cf. U.C.C. § 9-104(h)). The third party is not required to enter into the control agreement, nor is it required to confirm the existence of such an agreement, unless the grantor so requests: art. 2713.5 of art. 361 of New Bill; cf. U.C.C. § 9-342.

22 Cf. U.C.C. § 9-104: control is automatically achieved if the secured party is the bank’s customer with which the deposit account is maintained.

23 Art. 2713.6 of art. 361 of New Bill: A financial account is an account, other than a securities account within the meaning of the Act respecting the transfer of securities and the establishment of security entitlements (chapter T-11.002), to which amounts of money are or may be credited and for which the person maintaining the account, being the debtor of the credit balance, undertakes to consider the account holder as being authorized to exercise the rights relating to that balance.

24 Banks and financial services cooperatives, as well as brokers, trust companies, savings companies and persons who, in the ordinary course of their business, maintain financial accounts for others are persons maintaining a financial account.

25 Cf. U.C.C. § 9-104(a)(3). In obtaining control by becoming the account holder, the creditor becomes the « owner » of the account, which is not usually the most favored option for a creditor given the related costs and risks (complicating the debtor’s routine access to the account and possible tax liability for earning on the account): J.F. Brown, “Deconstructing DACA: An Analysis of the Model Deposit Account Control Agreement”, Commercial Lending Review (Sept.-Oct. 2006).

26 Art. 2713.8 CCQ of art. 361 of New Bill.

27 Art. 2743 CCQ.

28 Art. 2745 CCQ.

29 See e.g. s. 7 of the Ontario PPSA.

30 Art. 2713.4(1) CCQ.

31 For the validity of the security, the relevant time for consideration is when the security was created.

32 Cf. 9-304.

33 Art. 372 of New Bill.


35 Id at 9.

36 Art. 2713.4(2) of art. 361 of New Bill.


38 Regulations Amending the Transportation of Dangerous Goods Regulations (TC 117 Tank Cars), SOR/2015-100.

39 80 FR 26643.


41 S.C. 1996, c. 10.

42 2013 QCCS 4039.