

LITIGATION BULLETIN

May 2004

ONTARIO'S NEW LIMITATIONS ACT: IMPACT ON COMMERCIAL LENDERS

The *Limitations Act 2002* (Ontario) (the "New Act") came into force on January 1, 2004. The New Act makes dramatic changes to the law of limitation periods applicable in Ontario that will, in turn, have significant implications for lenders in respect of creating and recovering debt obligations. This bulletin summarizes certain of the principal changes and the impacts that they may have on lending and debt recovery practices for commercial lenders.

A. NEW LIMITATION PERIODS

The limitation periods under the New Act are as follows:

- (a) a two-year basic limitation period which runs from the date on which the claim is actually discovered or, if not actually discovered, when it should have been discovered by a reasonable person;
- (b) a fifteen year ultimate limitation period, which runs from the date that the underlying act or omission took place; and
- (c) no limitation period for certain claims, including proceedings by a debtor in possession of collateral in order to redeem it, or by a creditor in possession of collateral in order to realize on it.

These new limitation periods apply to all claims that arise after December 31, 2003 and to claims that arose prior to January 1, 2004 but were discovered or discoverable on or after January 1, 2004 and for which the limitation period under the former act (the "Former Act") had not yet expired. On account of the two-year basic limitation period, lenders must act promptly with respect to claims or potential claims against borrowers. A claim is defined in the New Act as a claim to remedy an injury, loss or damage that has occurred as a result of an act or omission.

B. EVENTS OF DEFAULT AND BREACHES OF COVENANTS

Some lenders may be concerned that a misrepresentation, breach of covenant or other default or event of default under a credit agreement or security document must be enforced within two years of its occurrence, even if the lender wishes to forebear enforcement, to avoid having the claim barred under the New Act. This concern is probably misplaced: the mere occurrence of a default, other than a failure to pay when due, would ordinarily not itself constitute an "injury, loss or damage", which would arise only after the lender has accelerated the loan and demanded payment and the debtor has failed to pay. The default is simply the event that gives the lender the contractual right to commence enforcement.

C. ACKNOWLEDGEMENTS

The New Act provides that a limitation period can be renewed through an acknowledgement of the claim by the obligor. Accordingly, if a borrower acknowledges that a lender has a claim, the two-year limitation period will be restarted, effective from the time of the acknowledgement.

Acknowledgments in writing will be effective to renew limitation periods for payment of liquidated sums, recovery of personal property, enforcement of a charge against personal property and relief from enforcement of a charge against personal property. In order to obtain protection from the defence that a limitation period in respect of a particular claim has expired, lenders should include an acknowledgement by the borrower of all outstanding claims in any credit

renewal, loan amendment or forbearance agreement. The acknowledgement mechanism provided in the New Act can be used by lenders to lessen the impact of the shortened limitation periods; however, it will not be effective for claims for specific performance and it does not eliminate the need for lenders to exercise diligence in monitoring their borrowers' performance and to take action when a default occurs.

Guarantees should also include an acknowledgement by the guarantor that the lender and the principal debtor may renew limitation periods without the necessity of obtaining the guarantor's consent. In addition, guarantors and lenders may consider using the acknowledgement mechanism to reduce the risk that their subrogation rights will be statute-barred as a result of their agreement to waive rights of subrogation until the creditor has been paid in full.

The New Act provides that a written acknowledgement of liability for interest is also an acknowledgement of liability for principal; however, the best practice would be to obtain a written acknowledgement of both principal and interest in all cases. The New Act also provides that part payment of a liquidated sum is an acknowledgment of liability for the entire debt, which will, in turn, automatically renew the limitation period for the entire debt. As well, performance of an obligation pursuant to a security agreement is an acknowledgement by the debtor of its liability in respect of a claim for realization on the collateral subject to the security agreement. It is unclear whether routine performance or observance of covenants included in the applicable loan or security documents (including negative covenants) will constitute an acknowledgement that has the effect of renewing limitation periods. Accordingly, lenders should obtain written acknowledgements, rather than relying on performance or observance of routine obligations or covenants under a loan or security agreement, in order to renew limitation periods.

D. LOAN SYNDICATIONS, TRUST INDENTURES AND ASSIGNMENTS

An assignee lender will be deemed to have its predecessor's knowledge of a claim for the purpose of the applicable limitation period, to the extent that the assignee is claiming through its predecessor in title to the claim. The limitation period in respect of a claim commenced by an assignee will begin to run on the earlier of: (i) the date the predecessor first knew, or ought to have known of the claim; and (ii) the date the assignee first knew, or ought to have known, of the claim. Similarly, in the case of a proceeding commenced by a principal, if the agent had a duty to inform the principal of its knowledge that a claim existed, the limitation period will begin to run on the earlier of: (i) the date that the agent first knew, or ought to have known, of the claim; and (ii) the date the principal first knew, or ought to have known, of the claim. In order to protect against a defence that a limitation period has expired prior to the commencement of an action, assignees should obtain acknowledgements from the debtor or guarantors at the time of assignment in order to "refresh" the two-year limitation period, if applicable. As well, documents establishing an agency relationship in a syndicated loan should clearly specify that the agent is not required to inform the principal of any claims against the debtor that it becomes aware of.

E. CONVERSION OF COLLATERAL

The New Act bars proceedings in conversion against a good faith purchaser for value of personal property two years after the date that the personal property was converted. This new provision is important for equipment lessors and asset based lenders, in particular, in that it limits their ability to pursue property which a borrower may improperly convey to a third party. A secured creditor seeking to take possession of collateral in the hands of a third party which purchased the collateral more than two years previously may be faced with the argument that its claim is statute-barred (even if that secured creditor has a perfected security interest against the transferred collateral). While we are of the view that a proceeding under the PPSA to enforce a perfected security interest in collateral should not be affected by this section, the outcome of such an argument before a court remains uncertain. Accordingly, in order to minimize the risk of losing the ability to claim the return of collateral, non-possessory security holders and lenders should be pro-active, conduct periodic inventories of the collateral subject to their security and exercise increased diligence in tracking the collateral.

F. DEMAND NOTES

While the New Act provides that the ultimate limitation period for demand notes under the New Act begins to run when the default in performing a demand obligation occurs, it is silent as to when the two year limitation period commences. At common law, the limitation period in respect of a demand note begins to run from the time of delivery of the demand note by the debtor to the creditor. While the issue is still not free from doubt, it is likely that the New Act supersedes this common law rule because the “injury, loss or damage” that gives rise to the “claim” has not occurred until demand and default. In light of the existing uncertainty, however, the prudent practice would be to assume the worst, namely that the common law rule continues to apply. Amortization payments under the applicable loan documentation made within two years of the delivery of the note would automatically restart the limitation periods. Also, the use of delay demand notes, which specify that the obligations of the debtor are payable a certain number of days after demand has been made, should be effective in reducing uncertainty, as the applicable limitation period would not begin to run until after the specified period of time had elapsed.

G. ENVIRONMENTAL CLAIMS

There is no limitation period for environmental claims that have not yet been actually discovered. However, once an environmental claim has been discovered, the two-year limitation period will apply. It should be noted that reasonable discoverability alone does not start the two-year limitation period; it must be actual discovery.

H. CHOICE OF LAW

The New Act also provides that the law of limitations is substantive law for the purpose of conflicts of laws rules. Accordingly, contracting parties may consider opting out of the regime under the New Act by choosing the law of another relevant jurisdiction to apply to their agreement. As well, the characterization of the laws of limitations as substantive law raises an issue as to whether the limitation periods in the New Act will apply to causes of action that are created under federal statutes, such as the *Bills of Exchange Act*, which does not contain a limitation period.

I. RECOMMENDATIONS

There remains much uncertainty surrounding the New Act and how it will be interpreted and applied by the courts in Ontario. Until the courts in Ontario are able to provide guidance as to the effect of the applicable provisions of the New Act, lenders and others involved in debt creation and recovery will need to exercise caution when creating debt obligations and exercising their rights of enforcement and recovery. Although the New Act contains certain useful mechanisms which will enable lenders to extend limitation periods, the most prudent course of action for lenders would be to institute timely and effective systems for the tracking of collateral, regularly monitor defaults, and institute proceedings as early as possible upon the discovery of default by an obligor.

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The foregoing provides only an overview. Readers are cautioned against making any decisions based on this material alone. Rather, a qualified lawyer should be consulted.

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