Business Law Bulletin

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STA ALERT: WHY YOUR PLEDGES OF LIMITED PARTNERSHIP UNITS MAY BE TICKING TIME BOMBS UNDER THE *SECURITIES TRANSFER ACT, 2006*

May Day! May Day!

May 1, 2007 is an important date for any lender whose loans are secured by pledges of securities, especially partnership interests, because April 30, 2007 marks the end of the four-month transitional period provided under the new *Securities Transfer Act, 2006* (the "**STA**"). *If you took a pledge of partnership units before January 1, 2007, you may be at risk of losing the benefit of your security to third parties or a trustee in bankruptcy of your borrower unless you act before May 1, 2007.*

The STA, which came into effect in Ontario on January 1, 2007, has clarified the law relating to pledges of securities in many important respects, especially with respect to indirectly held "book-based" securities, and it brings our law into line with revised Article 8 of the U.S. *Uniform Commercial Code*. But it also poses a number of new traps for the unwary, even where directly held securities are involved. One of these relates to pledges of interests in partnerships, such as limited partnership units.

Past Imperfect

Let's say that on November 1, 2006, Lender A loaned $10 million to Limco, a limited partner in ABC LP, a privately traded limited partnership that owns and operates several office buildings. Limco's only asset is its limited partnership interest. To secure the loan, Lender A took a pledge of Limco's limited partnership units ("**LP units**") and to do so had Limco deliver the endorsed unit certificates to Lender A. Lender A did not register a financing statement under the *Personal Property Security Act* (Ontario) (the "**PPSA**") because its counsel had assured Lender A that it could perfect its security interest in the units by physical possession of the unit certificates, and this would have priority over any security interest perfected by registration. After the new year, Lender A does nothing more with the file and keeps the unit certificates in its vault in Toronto.

On May 10, 2007, Limco is petitioned into bankruptcy by its unsecured trade creditors. This triggers an immediate default under its loan from Lender A, and Lender A sends a demand notice and accelerates the loan. Lender A is concerned about its borrower's bankruptcy but feels secure in the knowledge that it still has a pledge of Limco's partnership units in ABC LP, which is still solvent, and the market value of these units is at least $11 million. However, during the bankruptcy proceedings, the trustee in bankruptcy challenges Lender A's security interest and applies to the court to have it declared unperfected and ineffective against the trustee. Much to the horror of Lender A (and its counsel), the trustee succeeds: Lender A's security interest is declared unperfected, leaving Lender A with only an unsecured claim. The trustee seizes the limited partnership units and sells them for the benefit of Limco's unsecured creditors. Lender A realizes only 10% of the $10 million owed to it. How did this happen? How did Lender A's security interest, which it had perfected by possession on November 1 last year, suddenly become unperfected only a few months later?

When Securities Are Not Securities

It happened because some new provisions of the STA and the PPSA created a "perfect storm" for Lender A. First, a partnership unit is *not* a security covered by the STA and amended PPSA *unless* it is publicly traded or the limited partnership has "opted into" the STA by expressly providing (in the limited partnership agreement or the unit

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certificates) that each unit is a "security" for the purposes of the STA. ABC LP's limited partnership agreement was understandably silent on the application of the STA. Consequently, as of January 1, 2007, the LP units ceased to be "securities" under the PPSA and instead became "intangibles". The only way to perfect a security interest in intangibles is by registering a financing statement under the PPSA, which had not been done. However, Lender A's security interest did not become unperfected immediately on January 1. The PPSA provides for a four-month grace period where the secured party had a perfected security interest on December 31, 2006 but the actions taken to perfect that security interest under the old regime would no longer suffice to perfect it under the new regime. If a secured party in this situation re-perfects during the four-month grace period (following December 31, 2006) in a way that is effective under the amended PPSA, then its security interest remains perfected, with no gap. If, however, the secured party fails to re-perfect by the end of the four-month period (i.e., April 30, 2007), then on May 1 the security interest becomes unperfected. Under the PPSA, an unperfected security interest is ineffective against a trustee in bankruptcy. So, in our fact scenario, Lender A loses out to the trustee even though it formerly had a valid, perfected security interest.

So how could Lender A have protected itself? First, it could have registered a financing statement under the PPSA against Limco in respect of "accounts" and "other" before May 1. This would have sufficed to continue the perfection of the security interest in the LP units. In addition, however, Lender A should have required that Limco seek to have ABC LP amend its limited partnership agreement to provide that the LP units are "securities" for the purposes of the STA. This would mean that Lender A would have "control" of the LP units by virtue of its possession of the unit certificates and, if it took the pledge for value and without notice of any "adverse claims", it would become a "protected purchaser" that would take the securities free of any such adverse claims.

More Surprises

Consider another scenario: same fact situation as above except that this time instead of taking possession of the LP unit certificates, Lender A only registered a financing statement under the PPSA on November 1, 2006. Again, after January 1, 2007 it took no further action. However, unbeknownst to Lender A, on January 10, 2007, ABC LP amended its limited partnership agreement to provide that the LP units were "securities" for the purposes of the STA. Limco needs an additional $11 million in financing which Lender A cannot provide so it turns to Lender B. On March 1, 2007, as security for the new loan, Limco pledges its LP units and delivers the LP unit certificates to Lender B, without informing Lender B that the LP units are already subject to Lender A's security interest. When Limco is petitioned into bankruptcy on May 10, 2007, Lender B realizes on its security and sells the LP units for $11 million. When Lender A learns what has happened it demands that Lender B account to it for $10 million since Lender A had what it thought was a prior ranking security interest. Much to the horror of Lender A (and its counsel), the court rules in favour of Lender B. Why? Two reasons: First, a security interest perfected by "control" (which is what Lender B acquired by virtue of it taking possession of the LP units) takes priority over a security interest perfected by registration alone, regardless of which came first. Second, if Lender B qualified as a "protected purchaser", it would defeat any adverse claims to the LP units. The fact that Lender A had registered a PPSA financing statement would not itself put Lender B on notice of A's adverse claim: the STA provides that registration of a financing statement under the PPSA is not notice of an adverse claim, and the PPSA provides that registration of a financing statement is not constructive notice of its contents.

What if the LP units were uncertificated – i.e., no unit certificates were ever issued? Surely a financing statement would be sufficient then? Wrong again. If the LP units had been converted into "securities" for the purposes of the STA, Lender B could obtain "control" of them by entering into a simple agreement with the ABC LP (through its general partner) in which the general partner agreed to take instructions with respect to the LP units from Lender B. This would put Lender B in the same position it would be in if it had physical possession of the pledged LP unit certificates. Unless Lender A made specific enquiries of ABC LP as to the existence of any such "control" agreement, it would have no way of knowing that the agreement even existed. Regardless of Lender A's lack of knowledge, however, Lender B would still have priority.

These are only a few examples of how the new STA regime can hold some unpleasant surprises for lenders who assume that it's business as usual and that coming to grips with an entirely new statute can wait. May 1, 2007 is just around the corner, and those innocuous looking pledges of partnership units could be ticking time bombs waiting to detonate on May Day.

How MBM START Can Help

McMillan Binch Mendelsohn LLP was at the forefront of a commercial law reform campaign that helped to put the STA on the legislative agenda in Ontario in 2005 and our lawyers are well versed in the intricacies of this complex new legislation. To assist our clients in dealing with the STA, we have formed a *Securities Transfer Act* Readiness Team, or START. Someone from START or another member of our Debt Products Group would be glad to answer any questions that you may have about the impact that the STA may have on pledges of securities.

McMillan Binch Mendelsohn LLP, a leading Canadian business law firm, is committed to advancing its clients' interests through exemplary client service combined with thoughtful and pragmatic advice.

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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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