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• BASEL III — IMPLICATIONS AND OSFI GUIDANCE •

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• In This Issue •

The Basel Committee on Banking Supervision on December 16, 2010 released the final text of the Basel III Rules. On January 13, 2011, the Basel Committee issued final elements of proposed reforms to raise the quality of regulatory capital. Certain aspects of the Basel framework and in particular the timing of its implementation are subject to national discretion. On February 1, 2011, the regulator responsible for the solvency of Canadian banks and other deposit-taking institutions ("DTIs"), the Office of the Superintendent of Financial Institutions ("OSFI"), issued its action plan for the implementation of the Basel III Capital Adequacy and Liquidity Requirements in Canada. Subsequently on February 4, 2011, OSFI issued a draft Advisory concerning contingent capital and a release relating to non-qualifying capital instruments. This article summarizes both the Basel III Rules and OSFI's indication as to how these rules will be interpreted and enforced in Canada.

The Basel III Rules

The Basel Committee on Banking Supervision has stated that Basel III attempts to: (i) improve

• BANKS HAVE RIGHT TO HOLD TIGHT IN PAYING CHEQUES
ONTARIO COURT HOLDS
THAT BANKS NEED NOT BEAR THE RISKS OF CHEQUES BEING DISHONOURED •

Lisa Brost and Jeffrey Levine, McMillan LLP

Generally speaking, banks' customers have no immediate right to the proceeds of the cheques that they deposit. Under the terms of most banking services agreements, banks can place holds on cheques deposited by their clients for a reasonable period of time. Further, even if a hold is not put on a cheque, any advance of credit by a bank on deposit of a cheque is usually provisional in nature. The cheque may still be returned, or dishonoured, by the bank on which the cheque is drawn, leaving the bank that provided provisional credit in respect of the cheque with recourse to recover such amount from its client.

These guiding principles of the cheque payment process were recently considered by the Ontario Superior Court of Justice in *Re*Collections Inc v The Toronto-Dominion Bank*.[1] The plaintiffs in this action moved to certify a class action against three of Canada's six major banks (the "Banks"). In the proposed class action, the plaintiffs sought to recover profits that the Banks allegedly earned at their customers' expense through use of the proceeds of held cheques between the time that cheques were deposited by their customers and the time that the proceeds of the cheques were made available to the customers.

In dismissing the motion to certify the class action, the Court noted that banks exercise their contractual right to hold cheques in order to manage the risk that cheques will be returned or otherwise not paid. The decision highlights and validates this risk management practice.

The Facts

Whenever a cheque is deposited into an ATM, or when a teller determines it appropriate with respect to cheques deposited in person, banks place a hold on the cheque. This provides the bank at which the cheque is presented for payment (the "Collecting Bank") with an opportunity to ensure that the bank on which the cheque is drawn (the "Drawee Bank") will honour the cheque.

In *Re*Collections*, the banking contracts that the Banks had in place with each of the plaintiffs permitted the Banks to hold payment on cheques. The agreements also prescribed minimum and maximum periods during which a cheque might be held in different circumstances. The pleadings did not allege that any of the proposed plaintiffs had been subjected to hold periods that were longer than the periods prescribed in their respective banking contracts. However, the plaintiffs claimed that the Banks, when acting as a Collecting Bank, held cheques even after the Drawee Bank had cleared them and thereby breached the terms of the relevant banking contracts. The plaintiffs also alleged that the Banks breached a common law duty to release proceeds of cheques to the depositer within a reasonable period of time.

The Decision

To have a class action certified, the plaintiffs must demonstrate, among other things, that their pleading discloses a cause of action.

With respect to the plaintiffs' claim for breach of contract, the motions judge observed that a proper pleading of breach of contract requires the plaintiff to identify the term of the contract that had been breached. In this case, the motions judge held that the plaintiffs failed to identify and plead any express term of the relevant banking contracts that had been breached. While the Banks had provided explanations in the relevant contracts as to why they placed holds on cheques, none of the Banks promised that a hold would be released once the Bank was able to determine that a cheque had cleared. Accordingly, the pleading did not disclose a proper claim for breach of contract.

The motions judge found it unnecessary to address whether a common law duty to release the proceeds of a cheque deposited by a client within a reasonable period of time existed, as he found that even if there was such a duty, the parties had defined the length of that "reasonable period of time" in the banking contracts. There was no allegation in the statement of claim that this period had not been adhered to. Accordingly, the motions judge held that the pleading did not disclose a proper claim for breach of any common law duty.

The plaintiffs had also sought equitable remedies for breach of fiduciary duty and in unjust enrichment. The Court affirmed the longstanding principle that absent exceptional circumstances not applicable in this case, the relationship between a bank and its customer is a commercial and contractual one, not one giving rise to a fiduciary duty. The Court further held that no claim for unjust enrichment was made out on the pleadings because lack of a juristic reason for enrichment is a requirement for any claim in unjust enrichment. The lawful contracts between the Banks and the plaintiffs provided juristic reason for any enrichment on the part of the Banks.

In summary, the motions judge held that there were no tenable causes of action pleaded and dismissed the motion for certification.

The Banking Contract is Paramount

The decision in *Re*Collections* validates cheque hold policies and other risk management practices that allow banks to handle the inherent risks involved in dealing with cheques.

The decision may also serve as a reminder to banks' clients that credit provided by a bank upon deposit of a cheque is generally provisional in nature. The fact that a cheque is not held offers no assurance that a cheque will not ultimately be returned or dishonoured weeks, months or even years later. If a cheque is returned, the depositor will generally be obligated to the Collecting Bank for the amount paid on the cheque. Clients are thus well-advised to consider this risk in determining terms of payment.

Finally, the decision underscores the importance of the written contract between banks and their customers. Courts have repeatedly recognized that the relationship between banks and their customers are commercial and contractual in nature. Accordingly, the terms of a valid banking contract will govern the bank-customer relationship and banks are therefore well-advised to ensure that such a contract is in place with each client.

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1 [2010] O.J. No. 5686, 2010 ONSC 6560.

• STRATEGIES FOR MARGINING IN-TRANSIT INVENTORY •

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Introduction

In-transit inventory represents a significant, and growing, proportion of inventory for many borrowers, who often look to their lenders to advance against such inventory.[1]

As part of the lender's security package, the lender will have a security interest over the borrower's in-transit inventory. However, before the lender can consider including the inventory in the borrowing base, the lender needs to ensure that the borrower actually has title to the inventory. Further, unlike the typical situation where the inventory is located at the borrower's premises (where the lender will have access pursuant to the loan agreement/security documents and/or a landlord waiver), the lender does not have any control over what the borrower's carriers will do with the inventory.

After a brief discussion of some of the issues involved in confirming ownership of the inventory, this article will examine a few of the different strategies available to give the lender the comfort necessary to include at least a portion of the in-transit inventory in the borrowing base.

Ownership

As part of the due diligence/monitoring process, the lender must ensure that any margined inventory is actually owned by the borrower.

The sale agreement with the vendor will address the timing of title transfer. For example, if the terms indicate "FOB port" or "FOB shipping point"[2] the title will be deemed to have passed once the goods have been accepted by the borrower's carrier. In other words, the borrower will have title to the goods as soon as goods are in-transit. In this scenario, the buyer is responsible for the transportation arrangements and the buyer bears the risk of damage to the goods and would therefore be responsible for obtaining the cargo insurance.

While it is typical that the seller is responsible to deliver the goods to the buyer's carrier for transportation and that such delivery would mark the time when title passes to the buyer, it is also possible that the seller has agreed to make the delivery and that the title remains with the seller until such delivery is complete. This distinction is obviously crucial to the lender since the lender could make the mistake of including assets in the borrowing base which are not yet owned by the borrower. Therefore, the lender will need to carefully review the purchase documents.

Bills of Lading Made to the Order of the Lender

The lender's security interest in the collateral will, of course, be helpful to secure the lender's interest in the borrower's in-transit inventory, but it will not be sufficient to prevent a carrier from delivering goods to the buyer or otherwise contrary to the lender's wishes.

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