CAUTION

The **Professional Legal Training Course (PLTC)** provides the *Practice Material* to users as an aid to developing entry-level competence, with the understanding that neither the contributors nor **PLTC** are providing legal or other professional advice.

Practice Material users must exercise their professional judgment about the accuracy, utility and applicability of the material. In addition, the users must refer to the relevant legislation, case law, administrative guidelines, rules, and other primary sources.

Forms and precedents are provided throughout the *Practice Material*. The users also must consider carefully their applicability to the client's circumstances and their consistency with the client's instructions.

Professional Legal Training Course 2025

Practice Material

Business: Commercial

Recent Contributors:
Jonathan Considine
Amir Ghahreman
Alex McCrae
Jennifer To
Edward J.T. Wang

Practice Material Editor:
Katie McConchie

Printed for the May 2025 Session
of the Professional Legal Training Course

Law Society
of British Columbia

A requirement for admission to the bar of British Columbia, the Professional Legal Training Course is supported by grants from the Law Society of British Columbia and the Law Foundation of British Columbia.

BUSINESS: COMMERCIAL

CONTENTS

COMMERCIAL LAW

[§1.01] Introduction to These Materials 1

[§1.02] Glossary of Terms 1

[§1.03] Further Reading 3

BUYING AND SELLING A BUSINESS

[§2.01] Private Businesses 4

[§2.02] Stages in a Typical Transaction 4
1. Investigation Prior to the Transaction 4
2. Negotiating and Determining the Structure 5
3. Drafting and Signing the Agreement 5
4. Preparing for Closing 6
5. Closing 6
6. Post-Closing 6

[§2.03] Use of Checklists 6

[§2.04] Basic Structure of the Transaction 6
1. Identity of the Buyer 7
2. Subject Matter of the Transaction 7
3. Considerations in Price and Financing 7

[§2.05] Tax Considerations 7
1. Income Taxes 7
2. Sales Tax (GST and PST) 9

[§2.06] Due Diligence 9
1. Title, Liabilities and Encumbrances 9
2. Consents to Transfer 10
3. Minority Interests 10
4. Employee Considerations 10
5. Searches 10

[§2.07] Other Pricing Considerations 11
1. Agents' Commissions 11
2. Conveyancing Costs 11
3. Goodwill and Intellectual Property 12

[§2.08] Financing 12
1. Financing Options 12
2. Payment Clause 12
3. Seller Financing 12

[§2.09] Three General Drafting Considerations 13
1. Identifying the Parties 13
2. Defining Terms 13
3. Describing the Subject Matter 13

[§2.10]	Contents of an Asset Purchase Agreement	13
	1. Reasons for Buying Assets	13
	2. Description of Assets	14
	3. Exclusions	14
	4. Allocation of the Purchase Price	14
	5. Assuming Liabilities	14
	6. Releasing the Seller	15
	7. Determining the Purchase Price	15
	8. Representations and Warranties of the Seller	15
	9. Environmental Matters	16
	10. Covenants of the Seller	16
	11. Representations and Warranties of the Buyer	17
	12. Covenants of the Buyer	17
	13. Survival of Representations, Warranties and Covenants	18
	14. Conditions Precedent to Closing	18
	15. Documents Delivered at Closing	18
	16. Tax Considerations in the Agreement	18
[§2.11]	Contents of a Share Purchase Agreement	19
	1. Identifying the Parties	19
	2. Schedules	19
	3. Purchased Shares	19
	4. Price and Adjustments	20
	5. Representations and Warranties	20
	6. Survival of Representations, Warranties and Covenants	21
	7. Indemnity Clauses	21
	8. Conditions	21
[§2.12]	Restrictive Covenants on the Sale of a Business	22
	1. Purpose of a Restrictive Covenant	22
	2. Enforceability of a Restrictive Covenant	22
	3. Guiding Principles	22
	4. Drafting a Restrictive Covenant	23
[§2.13]	Impact of the *Investment Canada Act*	23
[§2.14]	Impact of the *Competition Act*	23
[§2.15]	Impact of the *Family Law Act*	24
[§2.16]	Impact of the *Indian Act*	24
[§2.17]	Impact of the *Proceeds of Crime (Money Laundering) and Terrorist Financing Act*	24
[§2.18]	Dispute Resolution	24
[§2.19]	Closing Procedures	24
	SECURITY IN COMMERCIAL TRANSACTIONS	
[§3.01]	Basic Concepts	26
	1. Types of Security	26
	2. Definitions	26
[§3.02]	The Concept of Security	27
	1. What is Security?	27
	2. Granting Security	28
	3. Kinds of Security	28

[§3.03]	*PPSA*—Overview	29
	1. Purpose of the *PPSA*	29
	2. Substance Over Form	29
	3. Deemed Security Interests	29
	4. Scope of the *PPSA*	30
[§3.04]	Attachment and Perfection	30
	1. Attachment	30
	2. Perfection	31
[§3.05]	Collateral Description	33
[§3.06]	Registration	34
	1. Perfection by Registration	34
	2. Notice System	34
	3. Elements of a Financing Statement	34
	4. Timing of Registration—Before Attachment	35
	5. Amendments to Existing Registrations	36
	6. Misleading Information	36
	7. Section 18 Demands	36
	8. Removing Invalid Registration	36
	9. Registration Not Knowledge	36
	10. Jurisdiction	36
	11. Searches	37
[§3.07]	Priorities	37
	1. *PPSA* Determines Priorities	37
	2. *Nemo Dat Quod Non Habet*	38
	3. Residual Priority Rule—Section 35	38
	4. Purchase Money Security Interests—Section 34	38
	5. Buyers and Lessees of Goods—Section 30	39
	6. Transferees of Negotiable Collateral—Section 31	39
	7. Lien Holders—Section 32	39
	8. Subordination Agreements—Section 40	39
	9. Other Priority Rules—Sections 29, 36, 37, 38, 39	40
	10. *Bank Act* Security	40
	11. Fixtures	40
[§3.08]	Enforcing Security Interests	41
	1. *PPSA* Part 5	41
	2. Contractual Rights—Section 58	41
	3. Sale of Seized Collateral—Section 59	41
	4. Payment of Sale Proceeds—Section 60	42
	5. Voluntary Foreclosure—Section 61	42
	6. Redemption and Reinstatement—Section 62	42
	7. Receivers—Section 64	43
	8. Consumer Goods—Special Enforcement Rules—Section 67	43
[§3.09]	Guarantees	43
	1. Why Get a Guarantee?	44
	2. Guarantee or Indemnity	44
	3. Co-Guarantors (Joint and Several Liability)	44
	4. Preparing a Guarantee	44
	5. Enforcement of a Guarantee	45
	6. Defences to the Creditor's Claim	45
	7. Assignment of Security and Liability	45
	8. Guarantor's Rights Against a Principal Debtor	45

[§3.10] Due Diligence 46
1. Corporate Power and Capacity 46
2. *Indian Act*—Section 89 46
3. Searches 46

[§3.11] Common Pitfalls 46

APPENDICES--*NOT AVAILABLE IN ONLINE VERSION*

Appendix 1 – Guarantee 48

Appendix 2 – General Security Agreement 51

Appendix 3 – *PPSA* Conceptual Schematic 57

INTRODUCTION TO FINANCIAL ACCOUNTING AND FINANCIAL STATEMENTS

[§4.01] Interpreting Financial Statements 58

[§4.02] Financial Statements—Generally Accepted Accounting Principles and Assumptions 58
1. Generally Accepted Accounting Principles 58
2. The Going-Concern Assumption 59
3. The Stable Unit of Measure Assumption 59
4. The Periodicity Assumption 59
5. The (Historical) Cost Principle 59
6. The Revenue Principle 59
7. The Matching Principle 59
8. The Objectivity Principle 60
9. The Consistency Principle 60
10. The Conservatism Principle 60

[§4.03] Financial Statements 60
1. The Balance Sheet 60
2. The Statement of Income and Retained Earnings 61
3. The Statement of Cash Flows 61
4. Notes to Financial Statements 62
5. Comparative Information 62

[§4.04] Accountants' and Auditors' Communications 63

[§4.05] Financial Statement Analysis 67
1. Comparative Analysis 67
2. Ratio Analysis 67
3. Liquidity Analysis 67
4. Solvency Analysis 68
5. Profitability Analysis 69

[§4.06] Conclusion 69

APPENDICES--*NOT AVAILABLE IN ONLINE VERSION*

Appendix 4 – Acme's Financial Statements 70

Appendix 5 – Acme's Ratios 74

Chapter 1

Commercial Law[1]

[§1.01] Introduction to These Materials

The practice of a commercial lawyer necessarily involves several areas of law. A commercial lawyer provides legal advice on the buying and selling of a business either by way of assets or shares. In addition, a commercial lawyer is often asked to advise on or to document transactions involving partnerships, joint ventures, employment issues, intellectual property issues, commercial leases, licence agreements, and security documents. It is, however, the buying or selling of a business that forms an integral part of the practice of many commercial lawyers.

The *Practice Material: Business: Commercial* reviews some essential considerations for a commercial lawyer. This chapter starts with a glossary of terms (additional terms pertaining to security are defined in Chapter 3). Chapter 2 reviews basic considerations when advising the seller or the buyer in the purchase and sale of a business. Chapter 3 canvasses security in loan transactions, with a focus on secured transactions involving the *Personal Property Security Act*. Chapter 4, the final chapter, provides an introduction to accounting and financial statements. The chapters also include appendices with examples of a guarantee, a security agreement and financial statements, among other things.

Specialized areas such as transportation, oil and gas or intellectual property are beyond the scope of these materials. For assistance in these areas, consult the reference materials published by the Continuing Legal Education Society of BC (www.cle.bc.ca), including those mentioned at the end of this chapter, and publications by other legal publishers.

[§1.02] Glossary of Terms

"**Accounts payable**": Amounts due to creditors (usually suppliers of goods and services).

"**Accounts receivable**": Amounts due from purchasers (usually customers for goods and services).

"**Accrual accounting**": Accounting model in which revenue is reported when it is earned, not only when it is received (compared to the "cash accounting" method).

"**Accrued liabilities**": Amounts owed, perhaps for expenses or losses, and not yet invoiced or paid.

"**Amortization**": This has two common meanings. The first refers to dividing the total principal and interest owing on a loan into equal amounts payable over the term of the loan. The second refers to the gradual expensing of the cost of long-term assets over their useful life.

"**Assets**": Resources that have monetary value to the owner, whether tangible or intangible (see also "Current assets" and "Fixed assets").

"**Balance sheet**": Reports the company's assets, liabilities and equity at a particular date. Assets should equal liabilities plus shareholders' equity.

"**Book value**": Value of an asset as recorded in the company's "books" or financial statements. The book value of a company is its total assets minus total liabilities. That value appears on the balance sheet as shareholders' equity in the company.

"**Canadian-Controlled Private Corporation**" ("**CCPC**"): a company that is neither public nor controlled by non-residents. A CCPC can obtain a "small business deduction" which reduces the corporate income tax it otherwise must pay.

"**Capital cost**": The initial cost of acquiring an asset.

"**Capital cost allowance**": A statutory form of depreciation/amortization allowable under the *Income Tax Act* and which is used for calculating taxable income.

"**Cash**": Cash on hand and balances in current bank accounts.

"**Cash-flow statement**": Statement showing the inflow and outflow of cash over a period of time, usually with reference to the income statement as a starting point.

"**Contingent liabilities**": Liabilities that depend on future events, such as pending lawsuits.

"**Cost base**": The amount the company paid for the asset (see also "Cost of goods sold").

"**Cost of goods sold**": Total expenses incurred in producing the goods that were sold.

"**Current assets**": Cash and resources that will turn into cash within the company's accounting cycle, typically one year from the balance sheet date.

"**Current liabilities**": Liabilities due to creditors within one year.

"**Current ratio**": See "Working capital."

"**Depreciation**": The gradual expensing of the cost of long-term assets over their useful life (sometimes referred to as amortization).

[1] Updated in 2024 by PLTC with the assistance of **Amir Ghahreman**, C.P.A., C.A., LL.B., Richards Buell Sutton LLP.

“**Depreciable Capital Property**”: Property in respect of which taxpayers are entitled to claim capital cost allowance. It includes tangible assets that are used to gain and produce income, such as buildings, machinery and software (compare to “Non-depreciable capital property,” below).

“**Eligible capital property”:** Property that entitles taxpayers to deductions that are similar to capital cost allowance but generally only half as generous. This includes goodwill, customer lists, patents and trademarks.

“**Expenses**”: Costs incurred to generate revenue.

“**Fair market value**”: A price that an independent purchaser would consider to be reasonable or that would occur between arm’s length parties.

“**Financial statements**”: Typical financial statements include at least a balance sheet, an income statement, a cash-flow statement and notes to the financial statements, and are prepared at least annually.

“**Fixed assets**”: Tangible assets that depreciate, such as equipment and buildings, but not land.

“**GAAP**”: Generally Accepted Accounting Principles. This is a widespread accounting standard having some variations depending on country and type of entity (i.e. private vs. public companies vs. non-profit).

“**Goodwill**”: Value in a business that is in addition to its identifiable tangible and intangible other assets. It is a subjective calculation of the value of things such as brand recognition, managerial excellence or customer loyalty.

“**IFRS**”: International Financial Reporting Standards are accounting standards to ensure global uniformity. Canada’s GAAP for all publicly accountable enterprises conforms to IFRS.

“**Income statement**”: A statement of income and expenses over a period of time. Usually prepared annually; it might also be prepared quarterly or monthly.

“**Inventory**”: Goods a company owns and intends to sell.

“**Liabilities**”: Debts or obligations both current and long-term (see also “Accrued liabilities,” “Contingent liabilities,” “Current liabilities” and “Long-term liabilities”).

“**Long-term liabilities**”: Obligations that are payable in more than 12 months’ time (see “Current liabilities”).

“**Loss carryforward/carryback**”: A company that has tax losses in the current year might choose not to apply those losses to offset its taxable income in the current year, but apply those losses to offset taxable income in future years, to reduce its tax liability in those future years.

“**Marginal tax rate**”: The percentage tax rate imposed on the next dollar of income earned by a taxpayer.

“**Marketable securities**”: An equity or debt instrument where there is a ready market and it can easily be sold.

“**Non-capital loss**”: Net tax losses from business or employment, as opposed to tax losses from the sale of capital property.

“**Non-depreciable capital property**”: Property for which no depreciation or capital cost allowance deductions are available; includes land and shares in corporations.

“**Operating expenses**”: Costs of a company’s normal operation over the period of time covered by the income statement on which the operating expenses are recorded.

“**Public companies**”: Corporations whose shares are listed for trading on a securities exchange. Often the term “reporting issuer” is used, which has a slightly broader definition under securities law.

“**Prepaid expenses**”: Advance payment for expenses that have not yet been incurred or fully utilized (such as an insurance policy). It is recorded as an asset on the balance sheet.

“**Recapture**”: A gain (for tax purposes) from selling an asset where the vendor’s proceeds exceed the undepreciated capital cost balance.

“**Retained earnings**”: Net profits that are not distributed to shareholders.

“**Revenue**”: A subset of income that arises from the sale of goods or services as part of an entity’s primary activities.

“**Security**”: Financial instrument that the holder can sell or pledge for value (see also “Marketable securities”).

“**Shareholders’ equity**”: The value of a company’s assets minus its liabilities (see “Book value”).

“**Shareholder loan**”: Corporate financing where a shareholder advances money to the company.

“**Shares**”: Partial holdings in the ownership of a company.

“**Undepreciated capital cost**”: The net balance (for tax purposes) of the value of a long-term asset, after accounting for applicable capital cost allowance, that is available for further depreciation.

“**Working capital**”: Current assets minus current liabilities. Current assets divided by current liabilities is the “working capital ratio” or the “current ratio,” which measures the company’s liquidity and its ability to meet its debt obligations.

“**Write-down**”: Reduction in asset value where the fair market value falls below the book value, often due to external factors such as economic downturn, obsolescence or lower market demand.

[§1.03] Further Reading

The Continuing Legal Education Society of British Columbia publishes relevant material:

Advising BC Businesses (loose-leaf and online)

Buying and Selling a Business—Annotated Precedents (loose-leaf and online)

Commercial Leasing—Annotated Precedents (loose-leaf and online)

Due Diligence Deskbook (loose-leaf and online)

Use of Financial Statements for Legal Professionals (May 2019)

BC Personal Property Security Act Practice Manual (loose-leaf and online)

Chapter 2

Buying and Selling a Business[1]

[§2.01] Private Businesses

This chapter reviews the processes involved in buying and selling a business (a private business in particular). This chapter looks at general concerns in buying and selling a business, then looks at particular concerns for sellers and for buyers. Additional concerns in buying and selling public companies are not addressed in this chapter.

For most clients, the purchase and sale of a business is a significant event. Clients should be aware that the transaction process is complex and often requires significant time and resources. It will also involve not only the client and lawyer but other professional advisors, including accountants, lenders, and business valuators, who are called upon to conduct specific due diligence. All of these parties need to work together to ensure that the client's interests are protected and the transaction is completed efficiently.

The transfer of a business raises a number of special considerations that may not apply to other types of transactions. For example, the buyer will typically need a reasonably high level of certainty about the status of the business. This is usually accomplished by the seller making representations and warranties about matters such as the nature of the seller's ownership of the business, the accuracy of the historic financial reporting, the status of major contracts affecting the business, and the transferability of major assets.

As this chapter outlines, a key component of any acquisition transaction is investigating the target and its assets and operations. A buyer wants to know whether there are any issues with what the buyer is buying, whether the seller or target company has title to the assets, and what liabilities the buyer is assuming.

The purchase and sale of a business may also require the consent of third parties. For example, the buyer may need approval from the Commissioner of Competition under the *Competition Act*, R.S.C. 1985, c. C-34.

A business transaction may be structured in a number of different ways. This chapter focuses on the most common forms—share purchases and asset purchases. Other methods of acquiring a business (not discussed in this chapter) include a hybrid of an asset and share purchase, amalgamations of a seller and buyer corporation, corporate arrangements, and takeover bids. The client often needs advice on how the purchase should be structured, and the lawyer or client might look to other professional advisors in determining the appropriate structure. The way the purchase is structured will have immediate cost consequences and will influence how the ongoing business operates.

[§2.02] Stages in a Typical Transaction

In general terms, a purchase and sale transaction can be broken down into the following distinct parts:

- structuring the transaction;
- investigation;
- drafting of documents;
- negotiation;
- preparation for closing;
- closing; and
- post-closing.

The structure of the transaction is generally settled early in the process as the choice of structure will affect investigation, drafting, and negotiation, and will determine the steps that must be taken to implement the transaction. Investigation and negotiation will take place concurrently, at least in part. Drafting of documents, including the principal agreements, takes place during the "negotiation" phase, and will be informed by the results of investigation. We will explore each of these transaction components in this chapter.

1. Investigation Prior to the Transaction

The first step is for the seller to decide to sell its business and to find a buyer who wants to purchase the business.

Often the parties enter into a "letter of intent" or similar form of non-binding agreement, stating the parties' intentions and the material terms of the transaction, including price and conditions.

The seller will disclose information to the buyer. Often, the buyer, the buyer's lawyer, and the buyer's accountants are all involved in checking that information. The lawyer's retainer should be clear

[1] **Alex McCrae, Jennifer To** and **Jonathan Considine**, Pearlman Lindholm, Victoria, revised this chapter in March 2024. In June 2022, the Solicitors' Legal Opinions Committee of British Columbia reviewed parts of this chapter relating to solicitors' legal opinions and provided suggested edits. This chapter was previously revised by Alex McCrae (2020, 2019 and 2017); Alex McCrae and Lindsay Ross (2013); Lisa Eastwood (2011); Valerie C. Mann (2008 and 2010); and Rita C. Andreone (1996–2006). James Reynolds provided comments about the *Indian Act* in June 2001. The portions of this chapter dealing with tax issues in relation to commercial buying and selling were drawn from former Chapter 7, contributed by Ed Kroft, KC, in 1989 and updated by the author until 2009.

about what responsibilities fall on the lawyer in the due diligence process and what responsibilities fall on the client and its other advisors. Usually the lawyer will help the client determine what type of due diligence to conduct.

When acting for the buyer, turn your mind to the following at an early stage in the transaction:

- Review several years of the seller's financial statements before committing to the transaction. The statements should report on the company's most recent financial period. If they do not, consider requesting current statements. The buyer's accounting advisors should provide input on the financial statements.
- When a material portion of the business's revenue is generated from only a few customers or clients, caution the client that it is vital that these contracts continue after the sale.
- Document the seller's initial representations and warranties about matters such as the accuracy of financial statements, capital expenditures, status of contractual arrangements, and status of any legal actions. These notes will help keep the negotiations consistent throughout the transaction. (These essential representations and warranties should be included in the final agreement of purchase and sale.)
- Consider whether any aspect of the transaction should be conditional on the business achieving certain sales or profits within an agreed-upon timeframe. Clarify definitions of terms like "sales" and "profits" early in the negotiations.
- Familiarize yourself and the parties with the key players (the subject business's accountants, bankers, and other advisors) and the key subject matter (the subject business's assets and any important contracts, including employment contracts and collective bargaining agreements).
- Early in the negotiations, contact anyone else whose consent to the transaction may be required so that their response will not delay the closing. This could include governmental authorities, the buyer's, auditors, directors, controlling shareholders, or others.
- Consider any initial tax issues, such as the seller's tax residency.
- Consider whether the *Proceeds of Crime (Money Laundering) and Terrorist Financing Act*, S.C. 2000, c. 17 imposes any obligation upon you or your client (or any other party to the transaction).
- Be aware of Law Society Rules 3-98 to 3-110 regarding client identification and verification, including the requirements that apply when a lawyer provides legal services for a "financial transaction" (defined in Rule 3-98). Note that in addition to verifying the client's identity, the lawyer must obtain information about the source of the money in relation to a financial transaction, and must periodically monitor the professional business relationship with the client. (See *Practice Material: Professionalism: Practice Management*, Chapter 7.)
- Express any doubts about the transaction early on and ask questions as they arise.

2. Negotiating and Determining the Structure

The parties will meet to decide how the transaction should be structured, who the buyer and seller will be, what the price will be, and how the price will be paid.

Ideally, the parties will seek legal and accounting advice about the structure of the transaction early in their negotiations. However, parties will sometimes present their lawyers with a general agreement or a letter of intent, having already determined the structure of the transaction. Even if the parties have an agreement, the lawyer should fully advise the client of the implications of the agreement and, if necessary, make changes.

The parties are working toward developing what is usually called a term sheet: a list of the terms for the transaction.

3. Drafting and Signing the Agreement

The buyer's lawyers often draft the term sheet outlining the main terms of the transaction. Whether you act for the buyer or the seller, you are typically in a better position if you control the documentation.

At this stage, you may or may not want to have a form of agreement that is legally binding on the parties. A letter stating the intention of the parties can be prepared. Take great care when drafting the option or letter as it will form the basis for the detailed agreement and may contain binding terms. If you intend to have a binding agreement at this stage, avoid including terms that contemplate the letter being followed by a more formal agreement, as such terms may make the agreement non-binding (see *Denison Mines Limited v. BP Resources Canada Limited*, [1991] B.C.J. No. 3563 (S.C.), and *Canlan Investment Corp. v. Gettling*, [1996] B.C.J. No. 1803 (S.C.), aff'd 1997 CanLII 4126 (B.C.C.A.)).

The agreement should set out the essential elements of the transaction. It may balance the interests of all parties or be more one-sided. If your approach is the latter, be prepared to defend that approach both to the other party's lawyers and to your own client, who may not appreciate your over-complication of the transaction, particularly if the deal is lost.

If you use precedents, you must review them carefully and critically. Make sure that you turn your mind to all the matters that are relevant to the transaction. The agreement should deal with representations as to the state of facts at present, covenants as to what the seller and buyer will do before the closing date, conditions of the obligations to close, and other matters.

The buyers will want to obtain as many representations, warranties, covenants and indemnities as possible. The buyers may also want security to protect them for a period of time following the closing (and sometimes indefinitely). The sellers will want to limit the representations, warranties, covenants and indemnities, and will prefer a limited scope and duration.

4. Preparing for Closing

The buyer will complete its investigation, ensure that the conditions for the buyer's obligation to close have been satisfied, complete its financing arrangements, formulate its takeover plan, and approve and sign all necessary documents.

The seller will ensure that it has complied with all its covenants and will approve and sign the necessary documents.

The seller may need to hold directors' or shareholders' meetings (or both) in advance to approve the sale, or may need to circulate a resolution to be signed by all persons entitled to vote on the matter.

Third party consents may also be required. Obtaining the required approvals and consents can require significant time, effort and expense. Take this into account so that the deadlines and costs for completing matters are realistic.

It is useful to track the steps of a transaction with a closing agenda. The closing agenda is usually a list of all documents, consents, and steps necessary to complete the transaction. The parties' lawyers decide amongst themselves who is responsible for preparing each of the necessary documents.

5. Closing

The agreement should provide a certain date on which the closing will take place. This may be a calendar date or a stated number of days following the occurrence of a particular event, such as the expiry of applicable waiting periods under the *Competition Act*, or a consent from a lender or landlord. The parties may want to fix an outside date by which time the transaction *must* have occurred, and if the date passes, then the transaction will terminate. Such a clause may be motivated by an actual need to complete the transaction before a specific date, or may just serve to provide some certainty about the time of completion. If necessary, the parties can renegotiate a later closing date.

At closing, the parties will ensure that all the conditions of closing are satisfied. The property being purchased will be transferred to the buyer and the purchase price will be paid to the seller. Typically, the exchange requires lawyers' undertakings. For example, the buyer's lawyer often disburses closing funds to the seller's lawyer on the seller's lawyer's undertaking to release financial charges against the business.

6. Post-Closing

Usually, the buyer's lawyers will register the conveyancing documents and complete any financing arrangements. Each party typically makes numerous covenants that must be completed after the closing.

[§2.03] Use of Checklists

Checklists are essential in commercial transactions. Refer to the *Practice Checklists Manual*, available on the Law Society of BC's website (www.lawsociety.bc.ca). Of particular interest are the following checklists:

- Asset Purchase Procedure
- Asset Purchase Agreement Drafting
- Share Purchase Procedure
- Share Purchase Agreement Drafting
- Commercial Lease Procedure
- Commercial Lease Drafting
- Security Agreement Procedure
- Security Agreement Drafting

[§2.04] Basic Structure of the Transaction

You should determine the basic structure of the transaction at an early stage of the transaction:

- **Who** will buy **what** from **whom**?
- What will the **price** be?
- Where will the **purchase money** come from?

1. Identity of the Buyer

Whether the buyer decides to make the purchase as an individual or through a company often depends on income-tax consequences, or considerations such as limited liability.

2. Subject Matter of the Transaction

It is essential to the transaction that the lawyer determine what is being bought. Two main possibilities exist: the first is for the buyer to buy the **assets** of the business; the second is for the buyer to buy the **shares** of the company that owns the business.

In an asset transaction, the parties are able to choose the assets that will be acquired, as well as the obligations and liabilities, if any, that will be assumed by the buyer.

In a share transaction, the buyer is buying the shares of the company, which owns assets and is responsible for obligations and liabilities. Unless the parties take steps before the closing to strip the company of certain assets, all the assets and all the liabilities of the company are the indirect subject matter of a share transaction.

There are many considerations to take into account when deciding whether the subject matter of the sale should be shares or assets, and these are discussed in the remainder of this chapter. Note that in reviewing the sections that follow, it may be helpful to refer to the glossary in Chapter 1.

3. Considerations in Price and Financing

Often it is preferable for the buyer to buy assets and for the seller to sell shares. Advantages to the buyer usually are offset by corresponding disadvantages to the seller. Therefore, a seller may demand a higher price to offset reduced net proceeds.

Other key considerations in pricing include the value of the underlying assets, which will involve due diligence in reviewing financial statements and security agreements as well as conducting searches, described in more detail in §2.06 below.

Another key consideration in setting the price is how the transaction is being financed, or where is the money coming from, which is described in more detail in §2.08 below.

[§2.05] Tax Considerations

1. Income Taxes

The income tax consequences are often a determining factor in structuring the transaction. Tax implications should be reviewed early in the negotiations.

The first step in the tax analysis is to determine the tax impact of buying assets or shares. In other words, which route will minimize the amount of tax dollars paid to taxation authorities? Next, you must consider other tax factors that are relevant only to the seller or buyer.

In considering the tax factors, note that the purchase and sale of a business (whether an asset or share deal) may be affected by the general anti-avoidance rules ("GAAR") in s. 245(2) of the *Income Tax Act*, R.S.C. 1985, c. 1 (5th Supplement), and s. 274 of the *Excise Tax Act*, R.S.C. 1985, c. E-15. The provisions may apply to deny the seller or the buyer a tax benefit resulting from a transaction, unless the transaction can reasonably be characterized as undertaken primarily for *bona fide* business purposes, and does not result in an "abuse or misuse" of the *Income Tax Act* or *Excise Tax Act*.

(a) The Seller's Position—Assets or Shares

The seller will want to compare the net after-tax proceeds from an asset deal with the net after-tax proceeds from a share deal.

(i) Asset Deal (Corporate and Personal)

A corporation is a separate legal person subject to taxation. When a corporate seller sells assets, the net after-tax sales proceeds received by the corporation will be taxed again when the corporation distributes those proceeds to its shareholders. Therefore, depending on whether and how proceeds are distributed from a corporation to the shareholders, there will often be additional tax payable by the shareholders.

The purchase agreement should document the purchase price and how much of that purchase price is allocated to each of the various assets being sold. In practice, this step is usually done with an accountant, but it is important for lawyers to be generally aware of the issues.

Considerations include the timing of dividends (to obtain a payout over time), the possibility of winding-up the corporation and distributing the proceeds; and whether the seller is a non-resident of Canada such that withholding taxes apply.

The CRA can apply s. 68 of the *Income Tax Act* to reassess the parties to the transaction and reallocate the price in accordance with what it concludes is commercially reasonable. However, when the parties are dealing with each other at arm's length, and actually document the allocation of the price, the CRA will generally not challenge their agreed-upon allocation of the purchase price.

(ii) Share Deal

To see which is the better deal, the seller of shares must compute any taxable gain and the tax payable on that gain, and then compare the net yield from the sale of shares with the after-tax amount that would be payable in an asset deal.

Individuals often prefer to sell shares because of the lifetime capital gains exemption available on the disposition of "qualified small business corporation shares."

A "qualified small business corporation share" meets these criteria:

- It is a share of a Canadian-controlled private corporation.
- The seller owned the share for at least 24 months before the sale.
- During the 24-month holding period, more than 50% of the fair market value of the corporation's assets were used principally in an active business carried on in Canada.
- At the sale date, all or substantially all (generally, this is 90% or more) of the assets were used principally in the active business.

(b) The Buyer's Position—Assets or Shares

(i) Asset Deal

An asset transaction has the following advantages from the buyer's point of view:

- The buyer does not inherit the seller's tax problems (although tax liens can attach to the assets).
- The buyer can be selective in choosing which specific assets are acquired.
- The buyer can write up assets to their fair market value, giving a higher depreciable base (subject to certain anti-avoidance rules). In other words, the buyer can write off the purchase of the assets over time.

The advantages to the buyer tend to be offset by corresponding disadvantages to the seller. Therefore, a seller may demand a higher price to offset reduced net proceeds. At the same time, the buyer may be willing to pay more for assets than shares because the buyer may obtain a higher cost base on which to claim capital cost allowance ("CCA"). This means the buyer can claim depreciation from its own adjusted cost base. Therefore, when negotiating the purchase price, the buyer should consider the present value of future CCA claims for the assets being purchased.

(ii) Share Deal

The tax aspects of a share deal are more difficult to assess than those of an asset deal. The buyer must analyze each of the company's underlying assets. The buyer's analysis should be informed by accounting advice, and usually includes at least the following considerations:

Tax Status of Assets

Review the market value of all underlying assets (or classes of assets) owned by the target company to be purchased in the share deal. If shares (not assets) are being purchased, the transaction loses the financial value of any increase to the adjusted cost base of the assets.

The adjusted cost base of depreciable capital property and eligible capital property (e.g. goodwill) should be carefully considered and adjusted, to benefit the company in future tax-related transactions.

Tax Accounts

Review the corporation's tax-free accounts, loss carryforward balances, and tax credit carryforward balances (e.g. investment tax credits). This includes reviewing whether the buyer can use these amounts as loss carryforwards, discussed below .

Loss Carryforwards

Consider if the target company has a loss carryforward balance.

Non-capital losses (from a company losing money) may be carried back three taxation years and forward 20 taxation years. They are deductible against any income source.

Net capital losses (usually resulting from a company selling a capital asset for less than it paid) may be carried back three taxation years and forward indefinitely. They are only deductible against taxable capital gains.

Tax Liabilities

Analyze the corporation's potential tax liabilities and adjust the purchase price accordingly. This analysis will include the following:

- requesting a clearance letter from the CRA and other tax authorities;
- reviewing prior tax payments to ensure that payments, installments, collections and remittances are up to date for all federal, provincial and foreign taxes including GST, withholding taxes, capital taxes, and employee withholdings (including CPP and EI);
- ensuring all tax returns and tax elections are filed to date; and
- determining any exposure to uncertain or contingent tax liabilities in connection with ongoing reassessments or for potential reassessments of tax returns in "open years" (that is, the years during which prior returns may be subject to reassessment). Returns may be subject to reassessment for up to seven years for some corporations, and indefinitely in circumstances of fraud or misrepresentation.

These items are often the subject of representations and warranties in a share purchase agreement.

Structure and Financing

Consider the buyer. Is it your client? A new corporation? For example, the buyer may choose to acquire the shares of the corporation through a holding company.

Financing is often necessary to fund the purchase price. In some circumstances, a seller might assist the buyer in financing the purchase price. Alternatively, the parties may negotiate an earn-out or reverse earn-out arrangement. An earn-out arrangement means the selling price will depend on future profits from the business sold. In any event, the buyer will seek to deduct any financing costs, including interest.

The seller may also request payment for any non-competition clause requested by the buyer. The amount received will be fully taxable except in limited situations.

2. Sales Tax (GST and PST)

The impact of sales tax is an important factor.

The sale of **assets** usually triggers the payment of sales tax. The *Provincial Sales Tax Act*, R.S.B.C. 2012, c. 35, imposes sales tax (PST) on tangible personal property and fixtures, as does the *Excise Tax Act*, R.S.C. 1985, c. E-15 (GST). Both statutes contain exemptions and elections, which may reduce or eliminate the imposition of these taxes.

In some circumstances, the buyer and seller elect to not have GST apply to the sale of the assets. Such election applies where the seller is selling "ownership, possession or use of all or substantially all" (usually interpreted to mean 90% or more) of the property required to carry on the business (or part of the business). This is a joint election which requires signatures from both the buyer and seller.

By contrast, the sale or transfer of **shares** will not trigger the payment of sales tax, so the buyer will not have to pay this tax.

[§2.06] Due Diligence

1. Title, Liabilities and Encumbrances

In an **asset** transaction, the buyer should ensure that the buyer's title to the assets is free of any encumbrances and any other rights of other parties to the assets, except for those agreed to by the buyer. The buyer should search title to registered assets, and obtain warranties and indemnities from the seller confirming that the seller owns those assets and can sell them.

Note that the value of warranties and indemnities is limited by the financial strength of the seller—if the seller has no financial resources, then the buyer may not be able to recover anything from the seller if the warranties turn out to be misrepresentations.

If encumbrances (such as mortgage debt) exist and will not be paid-out by the seller, the buyer should hold back part of the purchase price. If this is not appropriate, the buyer may want to seek a guarantee from a financially viable party on behalf of the seller, such as an individual shareholder or corporate parent of the seller.

In getting a guarantee, review the applicable corporate legislation or the company's constating documents to check for restrictions on providing financial assistance.

In a **share** transaction, the buyer should ensure that the company has title to or a legal interest in the assets that the buyer thinks it is buying (indirectly). The buyer will also be concerned about title to the shares, claims against the shares by any third parties, and the existence of encumbrances on the shares. The buyer should obtain representations and warranties on these matters and review the company's minute book (the record book where all material corporate decisions are recorded). The buyer should also explore all disclosed and undisclosed liabilities of the company. This is because the buyer is buying the business with all its assets and liabilities, including historical liabilities or obligations.

The buyer should review financial statements and obtain warranties and representations about the accuracy and completeness of those statements, including with respect to the liabilities of the company. Be wary if the books and records of the business are incomplete, or if the corporation is involved in other ventures (which may or may not be similar to the existing business of the company). If the financial statements have not been audited, or if they contain errors, there may be significant undisclosed liabilities, and an asset purchase may be preferable. The possibility of a significant unknown liability, such as product liability, professional negligence, or environmental hazards or liability, may dictate an asset purchase.

2. Consents to Transfer

In an **asset** transaction involving leases, timber licences, utility commission authorities, liquor licences, other licences or permits, or certain agreements, it is usually necessary to obtain the consent of the party granting the lease, licence or permit. This is because most of these are not transferable without consent, and if consent is not given, the transaction may be jeopardized. Applications for consent are generally not processed quickly, and the third party may require the buyer to post security for the obligations under the licence or permit. The amount of security may be significant.

In a **share** transaction, the transfer of certain leases, licences, authorities, permits, and agreements also requires consent, if the control of the party holding them changes.

3. Minority Interests

In an **asset** transaction, the company must not sell, lease or otherwise dispose of all or substantially all of its undertaking unless it does so in the ordinary course of its business, or as authorized by a special resolution (*Business Corporations Act*, S.B.C. 2002, c. 57, s. 301). In addition, the dissenting shareholders might have the right to be bought out (*Business Corporations Act*, ss. 237–247).

In a **share** transaction, the buyer typically wants to buy all of the outstanding shares. This may be difficult if there are minority shareholders who do not want to sell their shares. The compulsory acquisition provisions of the *Business Corporations Act* may have to be used so that the buyer can buy even if some minority shareholders do not want to sell (s. 300).

4. Employee Considerations

In a **share** sale, the buyer inherits the workforce of the business and all of the obligations of the employer to the various employees. Under s. 97 of the *Employment Standards Act*, R.S.B.C. 1996, c. 113, a person's employment is deemed continuous, notwithstanding a change in ownership of the company. Accordingly, under the *Employment Standards Act* the terms of employment simply continue (e.g. salary, bonuses, and notice of termination).

In an **asset** sale, the buyer *may* be able to select the workforce for the business and leave any severance or other obligations with the seller, to the extent permitted under the *Labour Relations Code* and the *Employment Standards Act*.

It is common practice for a selling party to terminate the employment of its employees prior to the sale of business, provided the buyer covenants to rehire the employees on the same terms and conditions. The implication is that the seller's severance obligations to the employees as of that juncture are left with the seller, but are not typically incurred, because the employees were rehired and suffered no loss of employment.

If an employee opts to not continue employment with the buyer, that employee is considered to have resigned and neither the seller nor buyer is required to provide notice of termination or compensation for length of service.

However, if there is a collective bargaining agreement in place, a successorship application will likely be made under s. 35 of the *Labour Relations Code*, R.S.B.C. 1996, c. 244 and the Labour Relations Board will likely hold that the union agreement binds the new buyer.

Note that an employer who intends to terminate the employment of 50 or more employees at a single location within any two-month period must give advance notice of that intention as set out in the *Employment Standards Act* (s. 64), and cannot alter the terms of employment during the notice period without consent of the employees involved.

5. Searches

The following is a list of common searches conducted by the buyer's lawyers:

(a) Registrar of Companies, for notice of articles and amendments, registered and records offices, annual reports, directors and officers, whether company was struck off the register and subsequently restored, and for certificate of good standing.

(b) Personal Property Registry, for notices of encumbrances on personal property.

(c) (i) Land Title Office, for charges on title of land owned by the seller, and copies of leases.

(ii) Indian Lands Registry System, if the seller leases all or part of the land used in the business and the land is situated on a reserve.

(d) Municipal offices, for business tax arrears.

(e) Civic and municipal offices, for licensing bylaws.

(f) City, municipal or provincial offices, for land taxes, and zoning or restrictive bylaws.

(g) Provincial government offices—for workers' compensation, sales tax, corporation capital tax, stumpage and other fees. The seller must submit a request in writing, or give written consent if the buyer is the party making the request.

(h) Canada Revenue Agency, for income taxes, including employee deductions and GST. The request must be in writing and include the seller's business identification numbers. The request can be made by the seller or by the buyer with the seller's written consent.

(i) Insurance agent, confirming placement of adequate new insurance.

(j) Bankruptcy and Official Receiver's Office.

(k) Sheriff's offices, for actions and executions.

(l) Court Registry (BC Online), for litigation.

(m) Employment Standards Branch, for certificates for unpaid wages.

(n) Better Business Bureau, for filed complaints.

(o) Superintendent of Motor Vehicles (depending on the nature of the business).

(p) Records office, for review of minute book (in share purchase agreements), looking for any matters of concern as follows:

- Identify mortgages, debentures and loans.
- Review articles to determine whether they restrict the transfer of shares and to determine the procedure for executing documents.
- Examine share registers, share certificates, waivers of preemptive rights, and resolutions authorizing issuance, transfer and buy-back of shares. The purpose of this search is to determine if shares are validly allotted, issued and fully paid, and how they are to be transferred and redeemed.
- If there are recent share transfers from spouses, consider entitlements to family property arising under the *Family Law Act*, S.B.C. 2011, c. 25 (see §2.15).
- Determine if directors' and shareholders' meetings have been properly constituted and the directors validly appointed.
- Determine if every transaction and material contract has been properly authorized.

(q) Consider searches for any special assets being acquired (for example, the Office of the Gold Commissioner for certain mineral claims or leases).

(r) Fees and payments under provincial legislation.

(s) Credit searches including Dun and Bradstreet and Credit Bureau.

(t) Ministry of Environment, to determine whether a target company or piece of property is subject to a pollution abatement order or has been the subject of investigations by the Ministry.

(u) Consider the impact of the *Family Law Act*, the *Investment Canada Act*, the *Competition Act* (that is, mergers and notifiable transactions), the *Excise Tax Act*, R.S.C. 1985, c. E-15, and any other relevant legislation.

For detailed checklists on searches conducted by the buyer's lawyers, consult the *Practice Checklists Manual* and the *Due Diligence Deskbook* (Vancouver: CLEBC).

[§2.07] Other Pricing Considerations

1. Agents' Commissions

In an **asset** transaction, commissions are often payable on land and other assets, reducing the return to the seller.

In a **share** transaction, agents' commissions are usually not payable unless a broker has been used.

2. Conveyancing Costs

In an **asset** transaction, an extensive set of conveyancing documents may have to be prepared, as set out in the Law Society's "Asset Purchase Procedure" checklist in the *Practice Checklists Manual*. There may also be substantial registration costs that would not be incurred in a share transaction, such as property transfer tax payable on the transfer of real estate, or other taxes payable on the transfer of chattels and personal property.

In a **share** transaction, normally only a few conveyancing instruments need to be prepared—see the Law Society's "Share Purchase Procedure" checklist.

3. Goodwill and Intellectual Property

In an **asset** transaction, you can allocate part of the purchase price to goodwill or to intellectual property. In a **share** transaction, the buyer may pay more for the shares than the sum of the values of the assets because of the goodwill or intellectual property of the company.

In an **asset** transaction, it can sometimes be difficult to transfer the corporate name and other intangibles that affect goodwill. In a **share** transaction, the buyer acquires the business and trade names, subject to any contractual rights that can be terminated on the transfer of the company.

[§2.08] Financing

1. Financing Options

The purchase price may be payable in cash, through the assumption of debt, or by the buyer giving other property to the seller.

Generally, the buyer finances the payment in one of the following ways:

- by deferring the payment of part of the purchase price to the seller ("seller financing");
- by borrowing from third parties; or
- by equity financing (finding additional investors willing to put money into the business by way of share capital).

For a discussion of borrowing from third parties, see *Practice Material: Business: Commercial*, Chapter 3 (Security in Commercial Transactions). For a discussion of equity financing, see *Practice Material: Business: Company*, Chapter 5 (Finance).

2. Payment Clause

High value payments should be made through Lynx, an electronic wire transfer system operated by Payments Canada for facilitating high value transfers. Lawyers should ensure that the purchase agreement authorizes a payment through Lynx where necessary.

Lynx operates on all weekdays that are not federal statutory holidays. Lynx processes payment activity on a cycle starting at 12:30 a.m. and ending at 7:00 p.m., Eastern Time. All transfers are settled on the books of the Bank of Canada at the end of the cycle. Though it is beyond the scope of these materials to address details of the Lynx system, lawyers must consider Lynx restrictions early in the transaction to determine if they will impact the transaction.

3. Seller Financing

If the seller is willing to wait for payment of part of the purchase price, seller financing is often the most convenient way to finance the purchase. It gives the buyer a holdback in case the seller has made misrepresentations. The agreement must provide for when and how the seller is to be paid, and for any security for the unpaid purchase price.

(a) Interest

When the seller is financing the sale, the following considerations often arise concerning interest on the payment price:

- Is the interest rate fixed, or based on the prime commercial rate of a particular bank?
- Should the price be negotiated on the basis of a relatively low interest rate with an increase in the rate upon default? (But see below on mortgages).

If the sale is to be secured by a mortgage of real estate, note the following requirements under the *Interest Act*, R.S.C. 1985, c. I-15:

- Section 8(1) prevents a higher rate of interest being taken on principal that is secured by a mortgage of real estate when the lender is in default.
- In an asset sale, if payments to the seller secured by a mortgage of real estate are to be based on a sinking fund plan or on a blended payment of principal plus interest, the rate of interest calculated yearly or half yearly (and not in advance) must be set out in a statement contained in the mortgage. Otherwise, no interest shall be chargeable, payable or recoverable on any part of the principal advanced (*Interest Act*, s. 6).

(b) Acceleration Clause

The agreement may provide that a default in payment or a default in any other covenant of the buyer will render the balance of the purchase price immediately due and payable. Depending on the terms of the agreement, the unpaid balance of the purchase price may also accelerate upon the insolvency or bankruptcy of the buyer, and may be automatic or upon notice.

(c) Security

The seller should secure the unpaid amounts in some way. This means that the unpaid amounts attach to some kind of asset. If the buyer defaults on repaying the seller, the seller can seize and sell (or keep) the asset. The security provided by the buyer to the seller can be anything that the seller is willing to accept, but often the buyer will mortgage back to the seller what the buyer has acquired from the seller.

In an asset transaction, the security agreement(s) will often charge the land, the major items of equipment, and the other assets of the company. The security could also include other assets of the buyer.

In a share transaction, the security will often take the form of security over the shares and security over the personal property of the company and the buyer itself.

(d) Guarantees

The buyer's principal shareholder, parent company, or another party may give a guarantee to the seller, as the whole security or in addition to a mortgage of the shares or assets. The party giving the guarantee (the "guarantor") can also give a mortgage of property as collateral security to the guarantee.

Generally, a company may give financial assistance for any purpose by means of a loan, a guarantee, the provision of security, or otherwise (*Business Corporations Act*, s. 195). If the acquired company is going to guarantee the unpaid portion of the purchase price and mortgage its assets as collateral to the guarantee, disclosure will likely be required (see s. 195). This is often a useful tool in providing security to the seller.

(e) Covenants

It is important that the buyer give positive covenants as to what it will do with the business and negative covenants as to what it will not do, or permit the acquired company to do, so as to protect the seller's security. For example, if the buyer is allowed to run the business (so as to affect it or the assets adversely before the purchase price is paid in full), the seller's security in the business will be of little or no value.

Default of these covenants should permit the seller to realize on its security. In addition, the seller should ensure that there is some way it can monitor the buyer's activities in the company, to make sure the buyer is complying with the covenants.

These are some of the matters that should be considered:

- the right to dividends;
- the right to redeem shares;
- the right to issue additional shares;
- the right to reduce capital;
- the right of the seller to receive a notice of meetings and financial statements; and
- the right to sell, mortgage or otherwise dispose of the shares or assets.

(f) Default

If one of the parties defaults, the property that was sold may need to be reconveyed to the seller. For instance, in a share sale, the seller may have to become the registered owner of the shares again. In an asset sale, the assets may have to be transferred back to the seller. The agreement should provide for this. Also, the parties must decide whether the seller has any right to the balance of the purchase price or to damages if the property has been returned, and whether the buyer has any right to the return of monies that have been paid.

[§2.09] Three General Drafting Considerations

1. Identifying the Parties

The parties to the agreement must be described in precise detail to ensure that they are easily identifiable. Corporations should include reference to the incorporation number.

2. Defining Terms

It is usual to define terms at the beginning of the agreement that, if repeated in full throughout the agreement, would make the agreement long and tedious. These are commonly defined terms: the parties; the purchased assets or shares; the business of the subject corporation; the financial statements of the subject corporation which the buyer is relying upon; the time and date of closing; the purchase price; and any other concepts that require some explanation and that arise more than once in the agreement.

3. Describing the Subject Matter

The seller must agree to sell, transfer or deliver, and the buyer must agree to purchase, pay for or receive the assets or shares of the subject corporation. The assets or shares should be described with sufficient detail to ensure that there will be no confusion as to the subject matter of the purchase.

[§2.10] Contents of an Asset Purchase Agreement

1. Reasons for Buying Assets

Tax considerations often are the principal reason for purchasing assets rather than shares, but there may be other reasons favouring an asset purchase. If the buyer suspects that the target company has significant liabilities that are not disclosed on its balance sheet, such as a potential product warranty claim or a potential tax assessment, the buyer may prefer to purchase assets. This is so that the buyer can limit the liabilities it is assuming to those agreed upon and reflected in the purchase price.

The buyer may also consider an asset purchase if the buyer is doubtful of persuading all of the shareholders to sell their shares, but is confident that sufficient shareholders are willing to sell so that a special resolution can be passed under s. 301 of the *Business Corporations Act* authorizing the directors to sell. However, a seller may be reluctant to pursue a special resolution because, if it is passed, shareholder dissent rights may be triggered under ss. 237 to 247 of the *Business Corporations Act*.

Another advantage to an asset purchase is that the buyer deals with only one seller, rather than potentially dealing with many shareholders.

However, an asset purchase has its disadvantages. Asset purchases will inevitably require more documentation, and produce greater frustration, penalizing both buyer and seller with higher legal and accounting costs. For the buyer, it will create sales tax obligations on tangible assets purchased, and property transfer tax and registration fees on real estate purchased. Not only must conveyances, bills of sale and assignments be prepared, but some transfers will require the consent of third parties whose consent may not be easily gained. In order to properly advise either a buyer or seller on the feasibility of an asset purchase agreement, the lawyer must examine the material contracts, leases, tenures and other rights in order to assess the ease or difficulty of obtaining all of the necessary consents.

Assuming that the preliminary investigations and assessments indicate that the party should proceed by way of an asset purchase, the respective lawyers must then settle the form of the asset purchase agreement. This chapter reviews clauses typical in an agreement designed to transfer a business as a going concern, with the buyer not only acquiring all of the assets used in the business, but also assuming some, though not all, of the indebtedness and obligations of the business.

2. Description of Assets

While general words might be used, the preferred practice is to provide a detailed description of all the assets being purchased, set out with sufficient certainty so that the same descriptions can be incorporated into the documents of transfer. This can best be accomplished through the use of schedules.

Since the buyer is not purchasing the corporation but only its assets, the buyer must specifically purchase the benefits of any contracts, agreements or leases of the seller. Ordinarily, these agreements will be assigned at closing, but the buyer should ensure in advance that the necessary consents are obtained.

3. Exclusions

It is necessary to expressly exclude any assets not being purchased, because the description of the assets is generally all-inclusive. Typical exclusions include the following: life insurance policies or leased vehicles for executives who will not be employed by the buyer; surplus funds held in the form of cash, deposits or marketable securities; insurance claims for past losses or damage to assets not being purchased; security posted to secure obligations under leases, permits, licences and prepaid expenses; and lawsuits against others that are of no benefit to the buyer.

4. Allocation of the Purchase Price

In an asset sale, the parties may agree to allocate the purchase price to particular assets. This section of the agreement is crucial when determining the true cost of the transaction to the buyer and the seller because of the tax consequences that follow from the allocation. The CRA is likely (but is not required) to accept the allocation agreed on by the parties if the parties are at arm's length and the allocation is reasonable.

5. Assuming Liabilities

"Assumed indebtedness," "assumed debt," or "assumed liabilities" are the seller's monetary liabilities, such as current accounts payable and bank loans, which the buyer will be responsible for after closing. The assumed liabilities should represent a credit against the purchase price.

Assumed debt will be identified by the seller in writing at the time of closing. The list of assumed debts should identify the creditor and the amount for each liability.

The buyer may also wish to assume certain contractual obligations in existence at the time the agreement is entered into. These can be identified in a "Schedule of Material Contracts" attached to the agreement. For greater certainty, the agreement can also expressly *exclude* certain contracts and commitments.

As will be discussed later, the buyer will generally want the seller to agree to carry on the business in the ordinary course between the date of the agreement and the time of closing. The buyer will want the benefit of any contracts entered into during that time period that benefit the business (e.g. agreements for the purchase of supplies). The agreement should therefore restrict the seller's authority to incur future obligations to those incurred in the ordinary course of business between the date of the agreement and the date of closing (or those agreed to in writing by the buyer), and commit the buyer to assuming those obligations. The agreement can also include further restrictions on the type, amount, or duration of future obligations that can be incurred without the buyer's written consent.

6. Releasing the Seller

The seller will want to be released from all "assumed liabilities" and other obligations being assumed by the buyer. The agreement should require the buyer to assume these agreements and enable the seller to be released from these obligations. To the extent that the seller cannot obtain releases, the seller will want the buyer to indemnify the seller against any claims for breach of these agreements.

7. Determining the Purchase Price

Arriving at the purchase price for a business can be a complicated matter. Often, the price is based on an estimate at closing and a final determination made after closing, once such things as current assets and current liabilities can be determined at the time of closing. For example, a purchase price might be a "net price" comprised of a fixed sum payable for all assets other than the accounts receivable, the inventories and the prepaid expenses, together with the actual value of the accounts receivable, inventories and prepaid expenses as they exist at the time of closing. From that total, the assumed debt will be deducted to arrive at the amount of the purchase price payable, in cash, on closing.

It can be difficult to determine the value of current assets such as accounts receivable and inventories. For instance, the parties may disagree on whether obsolete or slow-moving inventory should be included in the valuation. If such current assets form a significant part of the seller's aggregate assets, the parties should agree on the accounting principles that will be followed in arriving at their value. Either the seller's or buyer's accountants will be responsible for determining the net book value of the current assets in accordance with the agreed-upon accounting principles. The party not preparing this determination should have their own accounting advisor review and approve the calculations.

If the parties want the price to be determined *before* the closing date, then an "Effective Date" can be chosen as of which all price determinations are made and the final purchase price decided. Provisions are then included so that the seller will continue to operate the business from the Effective Date until the closing with all profits or losses being for the account of the buyer. Where the purchase price is being determined as of an Effective Date, the seller may insist that interest be paid upon the net purchase price from the Effective Date until the closing.

8. Representations and Warranties of the Seller

The representations and warranties will be similar to those contained in a share purchase agreement.

(a) Title to Assets

Typically the sellers warrant that they have good and marketable title to the assets, free and clear of all encumbrances (or subject to specified encumbrances).

(b) Authority to Sell

If the seller is a British Columbia company, its directors cannot validly authorize the sale of all or substantially all of the assets without the approval by special resolution of its shareholders (s. 301 of the *Business Corporations Act*). The approval should either be obtained before execution of the asset purchase agreement, or become a condition of the agreement that must be satisfied before the time of closing. Normally, the buyer will want the seller to deliver, at closing, evidence of its authority in the form of a certified extract of a directors' resolution authorizing the execution and implementation of the agreement, and a certified copy of a special resolution of the shareholders authorizing the directors to enter into and implement the agreement of sale. There is a similar requirement for shareholder approval in ss. 189(3)–(9) of the *Canada Business Corporations Act*.

(c) Default Provisions

The seller is usually required to represent that the sale will not result in a default under any agreements or give rise to the forfeiture of any assets. On an asset sale, that representation should be qualified where consents of lessors and other contracting parties are required in order to assign contractual or other rights.

(d) Pension Liabilities

Whether purchasing assets or shares, the buyer must be wary of employment matters, including assuming pension or benefit plans for employees of the business. For example, if a pension plan contemplates that the employees have the right to future benefits in the form of a minimum retirement allowance or in some other form, then the buyer must ensure that the plan is adequately funded as of the date of closing, to meet its future liabilities. When drafting the agreement, there should be a representation by the seller to produce at closing the certificate of an independent firm of actuaries certifying that the plan is fully funded.

Under an asset purchase agreement, any shortfall then can be treated as an assumed debt and credited against the purchase price. Under a purchase of shares, the shortfall cannot be treated as a credit and instead the seller should be obliged to fully fund the plan as a condition of closing.

(e) Residence of the Seller

If the seller is not a resident of Canada under the *Income Tax Act*, then the buyer is obliged to comply with the withholding provisions of s. 116 of the Act.

Section 116 applies to the disposition by a seller of "taxable Canadian property" as defined in s. 248 of the Act. "Taxable Canadian property" includes real property situated in Canada, as well as interests in corporations, trusts and partnerships that can hold real property, and units or interests in trusts resident in Canada.

Section 116 provides a system by which a non-resident seller of taxable Canadian property is required to report the disposition or proposed disposition of such property to the CRA, either before the disposition or within ten days after, and prepay tax on account of the actual income tax payable as a result of the disposition. This is accomplished either by the seller making the estimated prepayment of tax, in which case a certificate of compliance ("Clearance Certificate") is issued by the CRA certifying that this has been done, or by the buyer withholding an amount from the proceeds paid to the seller on account of such tax. Payments of tax sent to the CRA by the seller or the buyer are credited to the account of the seller until the seller files an income tax return for the year. When s. 116 is not satisfied, the buyer may be liable for the unpaid tax. Accordingly, the buyer should withhold sufficient amounts from the proceeds paid to the seller until the buyer receives a copy of a Clearance Certificate certifying that the seller has prepaid the required amount of tax.

In an agreement, it is customary to require a representation that the seller is a resident in Canada for the purposes of the *Income Tax Act*, but this does not relieve the buyer from the obligation to conduct reasonable inquiries. Depending on the circumstances of the transaction, it may be necessary to obtain statutory declarations from principal shareholders or from the corporate secretary of the seller.

9. Environmental Matters

A buyer of assets or shares must be satisfied that the seller and its predecessors have complied with environmental regulation. The cost of environmental clean-up can be unexpectedly high and can significantly affect the viability of a purchase. For instance, the contaminated sites regulations can impose retroactive and joint and several liability on those who have or had an interest in land, or those who possess or possessed land (see Part 4, Division 3 of the *Environmental Management Act,* S.B.C. 2003, c. 53, and Part 7 of the Contaminated Sites Regulation, B.C. Reg. 375/96).

Searches with public authorities may reveal known environmental concerns or issues. However, the environmental authorities and the seller may not be aware of latent or historical contamination. It is important to obtain representations from the seller about the business's compliance with environmental regulation, historical and present uses of the subject assets, and the extent of any known environmental contamination or liability. In addition, it is increasingly common for buyers to commission or require an environmental audit of the land to determine the nature and extent of any contamination.

10. Covenants of the Seller

The following are typical covenants of the seller.

(a) Conduct of the Business

The covenant of the seller to carry on the business in the normal course between the date of the agreement and the time of closing is the same for a sale of assets or shares.

The draftsperson must keep in mind the probable length of time between those dates. Normally a closing can be scheduled to occur as soon as the documentation and audit requirements can be met, which is usually about 30 days after the date of the agreement.

(b) Change of Name

If the buyer is acquiring the goodwill of the seller, and if the goodwill is in part attributable to the name of the seller, then the buyer will require the seller to covenant to change its name immediately after closing. Alternatively, the buyer might require that certified copies of a special resolution authorizing the change of name are delivered at closing so that they can be filed with the Registrar of Companies immediately after closing.

(c) Consents to Assignment

It is usual to require the seller to exercise all reasonable commercial efforts to acquire all consents necessary to effectively assign contractual rights; however, the seller may want a reciprocal obligation from the buyer to cooperate in obtaining those consents and to enter into assumption agreements if such are required. Buyers should be aware of whether they will be required to provide personal guarantees in place of a seller guarantee or other financial commitments to lenders, lessors or landlords.

(d) Termination of Employees

An area of concern to both seller and buyer under an asset purchase agreement is that contracts of employment will necessarily be interrupted and are not assignable.

The buyer may want to choose from among the seller's employees instead of hiring all of them. If the employees and managers of the seller's business are a desirable asset to the buyer, the agreement should be structured so that the seller is obligated to assist the buyer in negotiating employment contracts with those persons. The buyer will want the seller to terminate the employment of the employees that the seller does not want to select, and to be solely responsible for their severance claims.

Conversely, the seller will want the buyer to agree to hire all of the employees of the business in order to minimize the risk to the seller of severance claims. Whether the buyer agrees is a matter of negotiation between the parties.

As noted earlier, it may not be possible for the buyer to selectively assemble the workforce. If there is an existing union certification or collective bargaining agreement, the union will likely invoke the successorship provisions in the *Labour Relations Code* and the Labour Relations Board may hold that the existing certification and collective agreement bind the new buyer.

(e) Covenant of Indemnity

The buyer will want recourse against the seller if, after the closing, it turns out that the business has been misrepresented or the assets are subject to liabilities that the buyer did not agree to assume.

The buyer will typically require the seller to give indemnities for misrepresentation or breaches of covenants. In addition, indemnities can be negotiated for unassumed liabilities, pre-closing tax matters and responsibility for environmental issues. Indemnification should cover not only the loss suffered by the buyer (directly in an asset purchase or indirectly as the shareholder of the target company in a share purchase) but also the costs incurred by the buyer in enforcing its indemnification rights.

There is always a risk that the seller company is or will become a "shell" with no assets, or be wound up after the closing, and that any recourse against the seller alone will be illusory. One solution is for the buyer to insist that the principal shareholders of the seller join in the covenant of indemnity. The shareholders on the other hand will likely seek to limit their liability under the agreement.

11. Representations and Warranties of the Buyer

The buyer's warranties usually are limited to such basic matters as the buyer's capacity and authority to purchase, but may be extended depending on the circumstances of the transaction. For example, if the buyer is issuing shares to the seller as part of its payment for the business, the seller will want representations and warranties about the value of the shares.

12. Covenants of the Buyer

The following are typical covenants of the buyer.

(a) Offer Employment

As noted earlier, to minimize the risk to the seller of severance claims, the seller will want a covenant by the buyer to offer employment to employees of the seller. The seller may require a commitment by the buyer not to terminate employment without cause for a certain period after the closing.

(b) Consents

For the reasons already mentioned, the seller will usually require a covenant obligating the buyer to assist in obtaining consents of third parties to the assignment of contractual rights. This will normally require the buyer to enter into assumption agreements and to provide information about its operations and net worth.

(c) Assumption of Liabilities

The seller will require the buyer's covenant to assume and pay the liabilities agreed to be assumed, and to indemnify the seller against those liabilities.

(d) Covenant on Continuation of the Business

If the seller is providing financing to the buyer, and is looking to the continuation of the business as the source of repayment, then the seller may require both positive and negative covenants from the buyer with respect to the operation of the business. The usual practice, however, is to include those covenants in any security agreement entered into between the seller and the buyer.

13. Survival of Representations, Warranties and Covenants

The buyer will want the seller's representations, warranties and covenants to survive the closing, particularly where they relate to the existence of liabilities that will affect the ongoing business. Whether the seller is able to negotiate a limit on the duration and amount of that liability will depend on the circumstances and the seller's bargaining position. A common starting point for negotiating the appropriate time period is the amount of time it would take to complete a full audited year of business. However, the survival periods will depend on the subject matter, and need not be uniform.

The seller will want the buyer's covenant to assume liabilities and material contracts to survive the closing and to remain in force for the duration of those liabilities.

14. Conditions Precedent to Closing

An asset purchase agreement, like a share purchase agreement, will contain conditions that must be satisfied before the buyer and seller are obligated to close. The buyer will usually try to expand, as far as possible, the events that would allow it to not complete the transaction, while the seller will try to restrict these events.

In addition to the standard conditions about the truth of the representations and the performance of covenants, both the buyer and seller will want a condition in their favour that all necessary consents to assign the assets have been procured. That condition may have to be qualified so that it cannot be used as a pretext for avoiding the agreement. For example, the seller must show that it has exercised all "reasonable commercial efforts" to obtain the consents, and that the buyer has not waived the requirements for consent, before the seller can rely upon the condition to avoid the agreement. (Note that the phrase "best efforts", as opposed to "reasonable commercial efforts" is often a negotiated point between counsel; the phrase "best efforts" has been judicially considered and imposes a more onerous burden on the party agreeing to exercise them.)

15. Documents Delivered at Closing

If the buyer purchases assets, a number of transfer documents will need to be delivered. To the extent that conveyances, assignments and other transfer documents must be registered or recorded at any office or registry, the agreement may have to set out the mechanics to be followed so that registration can take place before the purchase price is paid. Usually, the lawyers agree to perform the necessary filings and registrations in accordance with normal conveyancing practices. These agreements and arrangements will be reflected in the closing memorandum.

16. Tax Considerations in the Agreement

(a) Accounts Receivable

When accounts receivable are sold, the sale generally gives rise to a capital gain or a capital loss for the seller, and results in the buyer having to treat any subsequent gain or loss on the receivables as a capital item. To avoid those consequences, the parties can file an election under s. 22 of the *Income Tax Act*. Most agreements of purchase and sale will include a covenant to file a s. 22 election.

A s. 22 election is available where a taxpayer has sold "all or substantially all" of the property used in carrying on a business to a buyer who proposes to continue carrying on the business. The additional requirements for a valid s. 22 election are that the business to which the receivables relate must have been carried on in Canada or the seller must have been subject to income tax in Canada on the receivables, the assets being sold must include outstanding debts that have been or will be included in computing the seller's income for the year or a previous year, and the buyer and seller must make the election by filing a joint election in Form T2022.

(b) Inventories

The asset purchase agreement should clearly set out the purchase price allocated to inventory, because the sale of inventory has specific tax consequences.

Under s. 23 of the *Income Tax Act*, when a seller sells all or part of the inventory of a business as part of the purchase and sale of a business, that inventory is deemed to have been sold in the course of carrying on the business. As a result, payments that the seller corporation receives for the sale of inventory are included in the seller's income.

The buyer may prefer to allocate a large portion of the purchase price to inventory, as this will result in a rapidly deductible amount for tax purposes.

(c) Prepaid Expenses

The seller may have prepaid certain expenses of the company. Section 18(9) provides that expenditures made or incurred by prepaid rent, interest, insurance, taxes and for services to be rendered in a subsequent taxation year are not deductible until the year to which the expense relates—that is, the year in which the taxpayer realizes the benefit of the prepaid expense. Therefore, the CRA administrative practice has generally been to include any payments from the buyer to the seller for prepaid expenses in the income of the seller. The buyer will benefit from a corresponding deduction in the year that the buyer realizes the benefit of the prepaid expense.

(d) Non-Depreciable Capital Property

The asset purchase agreement should stipulate what part of the purchase price is allocated to non-depreciable capital property (e.g. land).

The seller corporation will likely want as much of the price as possible to be attributed to non-depreciable capital property. This is because on the sale of non-depreciable capital property, the seller will realize a capital gain or capital loss (depending on whether the consideration received exceeds the cost base of the assets), resulting in income taxable only at capital gains rates. By contrast, proceeds attributed to depreciable capital property will result in income taxable at full rates to the extent of any recaptured capital cost allowance (CCA).

The buyer will usually want as little as possible of the total consideration attributed to non-depreciable capital property, because there is a greater tax advantage to attributing the consideration to depreciable capital property (i.e. the availability of CCA deductions to offset income in future years, described below).

The buyer must also consider property tax legislation, which may impose a tax on the purchase of real property. In BC, property tax is payable under the *Property Transfer Tax Act.* This tax is generally payable when the transfer of the property is registered in the Land Title Office.

(e) Depreciable Capital Property

Depreciable capital property is property for which the taxpayer can claim capital cost allowance (“CCA”). CCA is a permissive deduction which allows a portion of the property’s capital cost to the taxpayer to be deducted in computing the taxpayer’s income for the year from business or property.

The consideration attributable to depreciable capital property can have significant tax consequences to the buyer and seller (assuming the seller has claimed CCA). The agreement should clearly stipulate the prices attributed to various categories of property.

The seller usually wants to minimize the consideration attributable to depreciable property, to minimize recaptured CCA. The seller therefore will usually want more of the consideration allocated to non-depreciable capital property, because this will result in less tax payable by the seller.

In contrast, the buyer generally wants to attribute a high portion of the price to depreciable property, because it will increase the amount of CCA deduction available to the buyer in future years and thereby reduce taxes payable. As of January 1, 2017, goodwill arising from a business is classified as depreciable capital property, giving rise to a CCA claim by the purchaser.

[§2.11] Contents of a Share Purchase Agreement

Note: Much of the discussion in the preceding section on Asset Purchase Agreements is relevant to the discussion of Share Purchase Agreements, although not all of it is reproduced in this section.

1. Identifying the Parties

The buyer invariably will require a representation and warranty that the seller described in the agreement is the owner of the shares the buyer proposes to purchase, or that the seller has the capacity to enter into an agreement to sell the shares. This is particularly important if the seller is an agent, a trustee, or an executor under a will.

2. Schedules

The agreement usually provides a list of the materials that are to be appended to it as schedules, and a statement that those materials are incorporated into the agreement by reference. Materials that ordinarily are attached to the agreement as schedules include the financial statements of the subject corporation, descriptions of any contracts and insurance policies of the subject corporation, and descriptions of any leases and real property owned by the subject corporation. As well, certain important closing documents, such as non-competition agreements, releases and employment contracts, are settled before the agreement is signed and are attached as schedules.

3. Purchased Shares

The shares should be described precisely, to avoid any confusion about the subject matter of the purchase. The description should include the number and class of shares being purchased. If possible, the agreement should allocate a share price to each class of shares.

In some cases, the seller may not own or control *all* the shares of the subject corporation. In this situation, the seller may agree to cause the sale of the shares owned by minority shareholders.

4. Price and Adjustments

The price is usually the product of many hours of investigation by the buyer or the buyer's representatives, and intense negotiation between the parties. It is often expressed as a fixed dollar amount but (as with an asset purchase agreement) may be arrived at by an estimate and post-closing adjustment.

As well, particularly with transactions where there is significant lead-time between the execution of an agreement and the closing, the financial position of the company might change, so the parties should consider if the price should be adjusted in that case.

In other situations, the price may be determined at some future date, such as by way of an "earn-out" formula whereby the purchase price depends on the subject corporation earning profit in fiscal periods after the acquisition. The earn-out formula is popular where seller shareholders will continue in management positions and the buyer wants to ensure that they continue to be motivated to see the business succeed.

Paying the purchase price may take many forms, including the following:

- cash;
- promissory notes or other instruments of indebtedness;
- assuming liabilities;
- issuing shares of the buyer;
- exchanging property; or
- any combination of the above.

If the purchase price is not fully paid on closing, the buyer usually gives the seller security for the rest of the price. This security may come in several forms, including the following:

- the purchased shares are held in escrow, under an escrow agreement;
- the buyer gives the seller a mortgage on land or chattels of the buyer or subject corporation, if assets are purchased;
- the buyer gives the seller a fixed and floating charge debenture on the assets and property of the buyer or subject corporation;
- a corporation or individual acceptable to the seller provides a guarantee for the buyer's indebtedness; or
- any combination of the above.

The buyer will try to minimize the security it gives for the outstanding purchase price, whereas the seller will want to be well secured in case the buyer does not succeed in the new endeavour.

A buyer will ordinarily try to spread the payment of the purchase price over as long a period of time as possible so that the purchase price can be paid out of profits generated by the newly acquired business. Even where the buyer has sufficient funds, the buyer may prefer not to satisfy the whole purchase price at closing because the subject corporation may need funds.

Where a seller is not receiving all cash on closing, it will generally require interest to be paid on the outstanding amount.

5. Representations and Warranties

The buyer will attempt to obtain broad and comprehensive representations and warranties from the seller to ensure that it is getting what it has paid for.

Typically, the buyer will attempt to get representations and warranties from the seller that the subject corporation is duly incorporated, organized and subsisting under the laws of British Columbia and in each jurisdiction where it carries on business, and that both the authorized and issued capital are as stated. Often, the buyer will also require an opinion of the seller's lawyer to that effect. In certain circumstances, the seller may also require an opinion of the buyer's lawyer covering the same matters, particularly when the buyer will have obligations to the seller post-completion.

The buyer will invariably require a representation and warranty from the seller that the seller is the beneficial owner of the purchased shares free and clear of all liens, charges and encumbrances.

The buyer generally requires that the seller give a representation and warranty that the latest audited financial statements have been prepared in accordance with generally accepted accounting principles applied on a basis consistent with the previous years' financial statements. In some cases, the buyer will want similar representations and warranties with respect to the audited financial statements of the subject corporation for previous years, and any unaudited financial statements prepared since the last audited statement. (The buyer should be wary if financial statements are not audited, and should have an audit conducted before closing. The buyer's auditors should also verify financial information provided by the seller before closing.)

Other representations and warranties that the buyer will want from the seller concern these topics:

- accounts receivable, including the accuracy of their valuation and their collectability;
- amounts of salaries, bonuses and other consideration paid to parties not dealing at arm's length with the subject corporation;
- agreements entered into by the subject corporation and whether they are in good standing;
- pending or threatened litigation, or governmental or regulatory proceedings;
- the residency of the seller;
- the filing of tax returns and receipt of assessments;
- compliance with environmental law and environmental liabilities;
- approvals to the transfer of shares;
- dividends or other distributions to shareholders;
- liabilities incurred outside the ordinary course of business; and
- claims by First Nations.

6. Survival of Representations, Warranties and Covenants

The buyer generally tries to ensure that the representations and warranties of the seller, as well as certain covenants such as indemnities, survive closing indefinitely. The seller, on the other hand, invariably attempts to limit the period for which the representations and warranties survive. As in an asset purchase agreement, survival periods in a share purchase agreement may vary depending upon the specific matter addressed by the representation, warranty, covenant or indemnity.

The buyer will also try to ensure that no monetary limit is placed on the amount that the buyer may ultimately recover from the seller, while the seller will usually try to limit liability to a small portion of the purchase price.

7. Indemnity Clauses

The buyer will want recourse against the seller if, after closing, it becomes apparent that the business's assets and liabilities were misrepresented or that the shares of the company are subject to liabilities that the buyer did not agree to assume.

Consider whether an indemnity from the seller alone is sufficient, especially when the seller may become a shell company or otherwise not have the financial resources to satisfy a judgment against it. As discussed in the section on asset purchases, one solution is to insist that the principal shareholders of the seller or others with greater financial resources join in granting the indemnity; however, the shareholders will generally resist this or seek to limit their liability under the indemnity agreement.

8. Conditions

The completion of the transaction contemplated in the agreement of purchase and sale is invariably subject to conditions, for the benefit of either the buyer or seller, which must be fulfilled before closing. The buyer will usually try to expand the events which will allow it to not complete the transaction, while the seller will try to restrict these events.

The following conditions are commonly found in an agreement of purchase and sale for shares of a corporation.

(a) The covenants, representations and warranties of the seller will be true and correct as of the date of the agreement and the date of closing.

(b) The seller will have complied with all covenants and agreements contained in the agreement of purchase and sale, which commonly include the following:

  - it will have permitted the buyer, through its representatives, to investigate the records, property and assets of the subject corporation, among other things;
  - it will have delivered all ancillary agreements required by the agreement, such as non-competition agreements, releases, and resignations of directors and officers;
  - it will have delivered an opinion of counsel regarding such matters as title to any real property included in the subject corporation's assets, the due incorporation and existence of the subject corporation, the due creation and issuance of the purchased shares and other matters;
  - it will ensure that the subject corporation maintains all policies of insurance during the period from the date of the agreement to the date of closing;
  - it will have taken all necessary steps and proceedings as approved by counsel for the buyer to permit the purchased shares to be duly transferred to the buyer; and
  - it will have furnished the buyer with evidence that it is a resident of Canada within the meaning of the *Income Tax Act*.

(c) No substantial damage by fire or other hazard to the physical assets of the subject corporation will have occurred before the closing date.

(d) All government approvals will have been obtained, including, if necessary, under the *Investment Canada Act* or the *Competition Act*.

(e) Any consents required for the transfer of leases or contracts, triggered by a change of control in ownership, will have been obtained.

(f) The buyer will be satisfied with the financial condition of the subject corporation based on a report prepared by an accounting firm retained by the buyer.

(g) The buyer will be satisfied that there have been no adverse changes in the affairs, assets, liabilities, financial condition or business, either financial or otherwise, of the subject corporation since the date of the last audited financial statements until the closing date.

(h) The buyer usually has the right to rescind the agreement if a condition is not satisfied, or to waive a condition without prejudicing the buyer's right to rescind the agreement if any other conditions are not satisfied.

It is also common for the agreement to contain conditions that the buyer must satisfy before closing. For example, where the parties have entered into an escrow arrangement to finance the purchase, the seller ordinarily will require that, at closing, the buyer deliver the share certificates, representing the purchased shares duly endorsed for transfer.

[§2.12] Restrictive Covenants on the Sale of a Business

1. Purpose of a Restrictive Covenant

As part of the sale of a business (whether by share purchase or asset purchase), the buyer usually wants the seller to refrain from competing with the business the buyer just acquired. To that end, the parties will generally include a restrictive covenant in the sale agreement. The purpose of a restrictive covenant is to ensure that the buyer receives the benefit of the goodwill of the business purchased.

Restrictive covenants can be enforced by the courts by way of injunction or damages, or both.

2. Enforceability of a Restrictive Covenant

Restrictive covenants may be difficult to enforce. A restrictive covenant is a restraint of trade. As noted in *Shafron v. KRG Insurance Brokers (Western) Inc.*, 2009 SCC 6, at common law, restraints of trade are considered contrary to public policy, but the recognition of freedom to contract requires exceptions to this rule.

The test for enforceability of a covenant restraining trade is set out in the Supreme Court of Canada's decision in *Elsley v. J.G. Collins Insurance Agencies*, [1978] 2 S.C.R. 916. An enforceable restrictive covenant protects a legitimate proprietary interest, is fair and reasonable as between the parties and considering the public interest, and contains clear and certain terms of restraint.

The court will more closely scrutinize a restrictive covenant in a contract of employment than a restrictive covenant granted on the sale of a business. In making this distinction, the courts have recognized that there is often a power imbalance in the employee-employer relationship, whereas there is usually no such imbalance between vendors and purchasers in a commercial context.

As well, the vendor has received payment for goodwill, and more latitude is required in interpreting commercial agreements to protect freedom of trade and the stability of commercial agreements (see e.g. *Shafron*, and *Payette v. Guay Inc.*, 2013 SCC 45). As noted in *Elsley*: "a person seeking to sell his business might find himself with an unsalable commodity if denied the right to assure the buyer that he, the vendor, would not later enter into competition."

3. Guiding Principles

Whether a restrictive covenant is reasonable will depend on whether the covenant goes beyond what is necessary to protect the particular business. In assessing reasonableness there are three main areas of concern:

(a) the scope of trade restrained (that is, the extent of the activity prohibited);

(b) the territorial area within which trade is restrained; and

(c) the length of time that trade will be restrained.

For example, in *British Reinforced Concrete v. Schelff* (1921), 2 Ch. 563 (Eng. Ch. Div.), the Court found the restrictive covenant was too broad as to scope of trade because it restrained the *manufacture* as well as s*ale* of goods, whereas the business being sold had only engaged in the *sale* of goods.

The general rule as to territorial area of trade restrained is that the area must not be more extensive than the trading area of the business being sold. Note that the requirement to include a territorial limitation applies to non-competition clauses but not to non-solicitation clauses (see *Payette v. Guay Inc.*, in which the Court ruled that failure to include a territorial limitation in a non-solicitation clause did not support a finding that the clause was unreasonable, because in the modern economy customers were no longer limited geographically).

An ambiguous restrictive covenant is *prima facie* unreasonable and unenforceable: see *Shafron*.

4. Drafting a Restrictive Covenant

Because the purpose of the restrictive covenant is to protect the goodwill of the business sold, the drafter must understand such things as the nature of the business, the area in which business is carried on, the threat posed to the business if the seller were to compete, and the length of time required for adequate protection. The drafter must focus on the business as it exists at the time of the sale, rather than attempting to protect the business into the future. When drafting a restrictive covenant, the practitioner does the client a disservice by being over-protective; it is a much sounder practice to protect no more than is necessary in the circumstances.

In the past, it was common for lawyers to draft alternative restrictive covenants, expecting that the court could strike out any restrictions it deemed too broad and leave in place what the court considered reasonable (described as "blue-pencil" severance). For instance, lawyers might draft a time restraint as a covenant not to compete for (a) two years or (b) eight years, in the expectation that if the court found eight years unreasonable the court would strike it out but enforce the two-year restriction. However, subsequent decisions have cast doubt on this approach. See, for example, *Canadian American Financial Corp. (Canada) Ltd. v. King* (1989), 36 B.C.L.R. (2d) 257 (C.A.), where Justice Lambert held that alternative restrictions in restrictive covenants are not appropriate because the parties, not the court, need to agree on one specific time restriction and one specific geographic restriction.

In a 4–3 split, the Supreme Court of Canada endorsed a contractual doctrine known as "notional severance", which involves reading down a contract provision to make it enforceable (by substituting one term for another): *Transport North American Express Inc. v. New Solutions Financial Corp.*, [2004] 1 S.C.R. 249. In 2006, the British Columbia Supreme Court applied this doctrine to a restrictive covenant and substituted a two-year restriction for the five-year restriction in the contract (*Jones v. Prostar Painting and Restoration Ltd*., 2006 BCSC 1034). However, note that the Supreme Court of Canada has held that the doctrine of notional severance does not apply to restrictive covenants in employment contracts (see *Shafron*).

[§2.13] Impact of the *Investment Canada Act*

The *Investment Canada Act*, R.S.C. 1985, c. 28 (1st Supp.) regulates foreign investment in Canada. The general scheme of the *Investment Canada Act* is to require direct and indirect acquisitions of Canadian businesses by foreign nationals to be reviewed by the Investment Canada Agency when the value of the acquisition is of a certain type and exceeds a certain amount. The thresholds are adjusted annually.

Governments of WTO member states, and entities controlled by them, have a special status. Indirect acquisitions by WTO investors are subject to notification but are not reviewable, regardless of the value of the assets acquired.

For a reviewable transaction to be approved it must give a "net benefit" to Canada. The Minister of Innovation, Science and Economic Development considers the factors set out in the *Investment Canada Act* in deciding whether the proposed investment is a "net benefit", including the impact of the investment on the level of economic activity in Canada, and the degree and significance of participation by Canadians in the business (see *Investment Canada Act,* s. 20).

Except for investment in areas related to Canada's cultural heritage or national identity, investments by non-Canadians in new businesses are subject only to a requirement to file with the federal government a notice of the investment. The notice must be filed with Investment Canada up to 30 days after the investment occurs. If the transaction is deemed to have cultural heritage or national identity implications, it will be subject to a detailed review and assessment, with a specific review process for investments that might be "injurious to national security."

If the buyer of shares or assets is a non-Canadian, the Minister's approval will be required. Completion should be made subject to that approval.

If the company that is being acquired formerly obtained approval from Investment Canada, check whether the conditions of that approval bind a subsequent buyer, even if the subsequent buyer is a Canadian company.

[§2.14] Impact of the *Competition Act*

Any person proposing to invest in or expand a business carried on in Canada must consider the merger review and notification provisions of the *Competition Act*, R.S.C. 1985, c. C-34.

Merger transactions are subject to review by the Commissioner of Competition to determine if they substantially lessen or prevent competition, or are likely to do so. A "merger" is broadly defined as any acquisition or establishment of direct or indirect control over, or a significant interest in, a business (*Competition Act*, s. 91).

The Competition Tribunal has broad powers to intervene if a merger is likely to substantially prevent or lessen competition, including by making orders preventing or dissolving the merger.

Though all merger transactions are subject to review, Part IX (Notifiable Transactions) requires that parties notify the Commissioner of Competition before completing certain transactions. A notifiable transaction must meet certain thresholds:

- the size of the parties to the transaction and their affiliates exceeds CAD$400 million; and
- the size of the transaction (generally, the assets to be acquired in Canada or gross revenues from those assets) exceeds CAD$93 million.

Unless an exemption is available (see ss. 111–113), parties to notifiable transactions must notify the Commissioner, file certain information about the transaction with the Commissioner, and wait for up to 30 days before completing the transaction. Instead of filing a pre-merger notification, the parties can request an Advance Ruling Certificate. In either case a filing fee applies (in 2022, it was $77,452.36 plus GST).

[§2.15] Impact of the *Family Law Act*

The *Family Law Act*, S.B.C. 2011, c. 25 provides third parties with little protection against the possibility that an individual seller's spouse may have an interest in an asset (for example, a share in a non-reporting company). One method of protection is for buyers to obtain a covenant of the seller to deliver the following statutory declarations:

(a) a statutory declaration of the seller, on closing, stating that the seller is not married or living in a common law relationship; or that the seller is married or living in a common law relationship but has not separated; or that the seller was married or living in a common law relationship that has been terminated and all property matters between the parties have been resolved; and

(b) a statutory declaration of the seller with a covenant to deliver a release of any interest in the assets in question from any person to whom the seller has been married or with whom the seller has lived in a common law relationship, if the marriage or relationship has not been terminated and property matters between the parties have not been resolved.

[§2.16] Impact of the *Indian Act*

If the business is situated on a reserve, consider the federal *Indian Act*, R.S.C. 1985, c. I-5. Most reserve lands in BC are governed by the *Indian Act*, unless the Indigenous group has entered into agreements with the federal government regarding reserve lands. (The *Practice Material: Real Estate*, §1.04 discusses types of interests in reserve lands.)

The interest of the seller in any reserve lands governed by the *Indian Act* will be leasehold. You must review the relevant terms of the lease and any head-lease to determine what consents are required for any assignment of the seller's leasehold interest. You should also obtain a full search from the Indian Lands Registry System in Ottawa, and review all documents relevant to the seller's interest.

For the sale of a business on reserve land, consult CLE resources, such as the *Due Diligence Deskbook*.

[§2.17] Impact of the *Proceeds of Crime (Money Laundering) and Terrorist Financing Act*

See *Practice Material: Professionalism: Practice Management*, Chapter 7.

[§2.18] Dispute Resolution

Parties to a transaction might choose to specify in their agreement that, in the event of a dispute, they will seek a particular form of dispute resolution such as arbitration or mediation instead of resorting to traditional litigation.

In BC, two statutes apply to commercial arbitration: the *Arbitration Act*, R.S.B.C. 1996, c. 55, applicable to domestic disputes, and the *International Commercial Arbitration Act*, R.S.B.C. 1996, c. 233, applicable to international commercial arbitrations.

[§2.19] Closing Procedures

The following list summarizes some of the main closing procedures:

1. If the seller is a company, obtain a directors' resolution from the seller authorizing the sale. If substantially all assets of the company are being sold, obtain a shareholders' resolution *(Business Corporations Act*, s. 301).
2. If the buyer is a company, obtain a directors' resolution from the buyer authorizing the purchase.
3. Ensure that the agreement and documents of transfer and conveyance cover all assets purchased.
4. If the seller is a company transferring real property, ensure that you obtain all the signed acknowledgements that are required by the Land Title Office to transfer properties.
5. If bank accounts are being transferred, ensure that new banking forms are prepared for filing with the bank and that the bank is notified.

6. Ensure that the buyer produces sufficient monies to cover GST, if the buyer has warranted to do so.
7. If the seller is a non-resident of Canada, ensure that a certificate has been obtained or monies withheld under s. 116 of the *Income Tax Act*.
8. If notice of dissent under s. 301 of the *Business Corporations Act* has been given, ensure that the company has given shareholders notice of its intention to act.
9. If it is a share transaction, record the transfer in the share register, issue new shares, and cancel old shares.
10. Prepare employment contracts if they are required.
11. Prepare documents securing any unpaid purchase price.
12. Ensure payment follows the statement of adjustments (the document calculating the adjustments to the purchase price that the buyer and seller have agreed to make under the purchase agreement).
13. Obtain waivers of preemptive rights to shares, if required.

The lawyer's legal opinion, confirming the execution of and sufficiency of the previous steps, may be the final step the lawyer takes on the file.

For detailed checklists on closing procedures, consult the "Asset Purchase Procedure" and "Share Purchase Procedure" checklists in the Practice Checklists Manual on the Law Society website: www.lawsociety.bc.ca.

Chapter 3

Security in Commercial Transactions[1]

[§3.01] Basic Concepts

1. Types of Security

Creditors may lend money without taking security, but taking security places creditors in a stronger position to recover the debt. Secured creditors take an interest in the debtor's assets. If the debtor fails to repay the debt, the secured creditor can generally seize the debtor's assets (over which they took security) and sell them.

The *Personal Property Security Act*, R.S.B.C. 1996, c. 359 ("*PPSA*") provides a comprehensive and technical set of rules that govern the rights of creditors and debtors when personal property is used as collateral to secure payment of a debt. The statute creates one registration system, one set of priority rules and one set of rules governing the rights and remedies of secured parties upon default by the debtor.

In advising a creditor concerning a transaction, consider the following questions:

(a) Does the *PPSA* apply to this transaction?

(b) If so, have appropriate steps been taken to protect the creditor's security interest?

(c) What is the creditor's priority as compared to other creditors or competing claims to the collateral?

(d) Is the collateral investment property? If so, do special priority and perfection rules apply?

(e) Ultimately, what are the creditor's rights and remedies if the debtor defaults?

This chapter gives an overview of the *PPSA*, then goes into detail about perfecting security, registering a security interest, priorities between secured creditors, and remedies. The *PPSA* is quite technical. This chapter emphasizes the need for due diligence and identifies some common pitfalls that create difficulties for lawyers (see §3.11 for some examples). It is *essential* to read the legislation and consider it in the context of *each* transaction.

This chapter defines some key terms below. It also describes the **Policy** behind specific rules and concepts, and contains italicized notes in text boxes to emphasize key principles. At the end of the chapter, three appendices illustrate processes and forms used in particular transactions:

- Appendix 1 is a sample guarantee;
- Appendix 2 is a sample general security agreement; and
- Appendix 3 is a conceptual schematic.

2. Definitions

Section 1 of the *PPSA* sets out most of the Act's defined terms. While understanding *all* of the definitions is critical to using the *PPSA*, the following excerpted definitions help explain how a creditor takes a security interest.

Appendix 3 at the end of this chapter is a one-page schematic diagram that may be useful to refer to when you review the definitions.

"**chattel paper**" (formerly called a "chattel mortgage") means written evidence of both a monetary obligation and a security interest in goods.

"**collateral**" means personal property that is subject to a security interest.

"**consumer goods**" means goods that are used or acquired for use primarily for personal, family or household purposes.

"**debtor**" means, among other things,

(a) a person who owes payment or performance of an obligation, whether or not that person owns or has rights in the collateral,

(b) a person who receives goods from another person under a commercial consignment,

(c) a lessee under a lease for a term of more than one year, or

(d) a transferor of an account or chattel paper.

"**default**" means,

(a) failure to pay or otherwise perform the obligation secured when due, or

(b) an event or set of circumstances that, according to the security agreement, causes the security interest to become enforceable.

[1] **Edward J.T. Wang** of Borden Ladner Gervais LLP reviewed this chapter in February 2024 and previously updated it in 2023, 2021, and 2019. In June 2022, the Solicitors' Legal Opinions Committee of British Columbia reviewed parts of this chapter relating to solicitors' legal opinions and provided suggested edits. Previously updated by PLTC in 2018 (drawing on a 2017 CLE presentation by Mark R. Davies, with permission); Tanveer Siddiqui (2014); Kendall Andersen and Edward Wang (2012); and Vivian Tang, with the assistance of Eric Little (2010). Kendall Andersen and Magnus Verbrugge contributed this chapter and updated it annually to 2009.

"**financing statement**" means the document that describes a charge on property. It is a document filed electronically with the Personal Property Registry ("PPR," see §3.06).

"**goods**" potentially includes all tangible personal property, fixtures, crops, and unborn young of animals (note that crops are separately defined in s. 1(1)). It does not include chattel paper, documents of title, instruments, securities, money, trees (until they are severed), or minerals or hydrocarbons (until they are extracted).

A "good" is classified according to the *use* that the debtor makes of it at the time that the security interest "attaches" ("attachment" is discussed in §3.04). For example, a computer may be inventory if a merchant holds it for sale, equipment if it is used for business, and a consumer good if it is used primarily for personal purposes. Classification of goods matters for perfection and priority, discussed in §3.04 and §3.07.

These are important subcategories of "goods":

- ***consumer goods***

  goods that are used or acquired primarily for personal, family or household purposes;

- ***inventory***

  goods that are held for sale or lease, or are raw materials, work-in-progress or materials used or consumed in a business; and

- ***equipment***

  goods that are neither consumer goods nor inventory.

"**intangibles**" means personal property that is not goods, chattel paper, documents of title, money or investment property, but does include licences.

"**personal property**" as defined in the Personal Property Security Regulation (the "Regulation") for the purposes of both the Regulation and the *PPSA* includes:

(a) goods (including fixtures and crops);

(b) chattel paper;

(c) investment property;

(d) documents of title;

(e) money; or

(f) intangibles.

"**secured party**" means,

(a) a person who has a security interest, or

(b) a person who holds a security interest for the benefit of another person.

"**security agreement**" means an agreement that creates or provides for a security interest.

"**security interest**" means,

(a) an interest in goods, chattel paper, investment property, a document of title, an instrument, money or an intangible that secures payment or performance of an obligation, and

(b) whether or not the interest secures payment or performance of an obligation, the interest of

  (i) a transferee arising from the transfer of an account or a transfer of chattel paper,

  (ii) a person who delivers goods to another person under a commercial consignment, and

  (iii) a lessor under a lease for a term of more than one year.

Further to those definitions listed above, the *PPSA* has adopted some definitions found in the *Securities Transfer Act* ("*STA*"). Understanding the interplay between the *PPSA* and the *STA* helps evaluate competing security interests in investment property. These terms from the *STA* are relevant to the *PPSA*:

"**certificated security**" means a security that is represented by a certificate.

"**protected purchaser**" is not defined in the *PPSA* but in the *STA*, and it means a purchaser of a certificated or uncertificated security, or of an interest in the security, who gives value and obtains control of the security, without any notice of adverse claims to the security.

"**security**" means (except as otherwise provided in sections 10 to 16 of the *STA*) a medium of investment, or an obligation of an issuer or a share that can be traded on securities markets or exchanges.

"**security certificate**" means a certificate representing a security, but does not include a certificate in electronic form.

"**uncertificated security**" means a security that is not represented by a certificate.

[§3.02] The Concept of Security

1. What is Security?

> *"Security" is an interest in property given in support of a promise to pay or do something.*

"Security" is collateral. It is a way of enforcing a debtor's promise to pay, or providing a creditor with compensation if the promise is not kept. If the debtor does not pay the money or perform the obligation promised to the creditor, the creditor may turn to the security pledged by the debtor, possibly by seizing or selling it.

Many, but not all, commercial transactions involve security. Security is usually given to a creditor in transactions where the debtor must pay money to the creditor after the transaction has closed.

Many terms are commonly used to refer to an interest in property given by the debtor as security for its obligations. These words are often used interchangeably, and may include charge, lien, security interest, mortgage, hypothecation and pledge. For clarity, we will use the terms "charge" or "security interest" in most cases throughout this chapter.

2. Granting Security

> *Virtually any property can be offered as security for any obligation.*

A creditor is not required to take security. Many debt obligations are unsecured: a promissory note is an example. An unsecured creditor takes the risk that the debtor who fails to repay the debt might have no assets the creditor can pursue (or none that are free of charges by other creditors).

Unlike unsecured creditors, secured creditors do not need to obtain judgment before recovering assets pledged as security. The secured creditor may simply take steps to realize on its security to satisfy the debtor's obligations.

Taking security usually involves signing a security agreement. Section 9 of the *PPSA* provides: "Subject to this and any other enactment, a security agreement is effective according to its terms." While the parties to a security agreement can structure their deal according to terms they see fit, many of the *PPSA* provisions are mandatory. To be effective, the security agreement must comply with the *PPSA*. For example, there are certain restrictions on security agreements for consumer goods. The policy behind this restriction is that consumers are vulnerable to "sharp" commercial practices, and without the protection of the *PPSA* they might sign security agreements that are unfair.

While a security agreement could be short, in practice they are often very long, stretching to 20 pages or more. So long as the security agreement is signed by the debtor, includes a clause granting a security interest, describes the collateral in accordance with s. 10 of the *PPSA*, and describes the obligations secured, it will be enforceable according to its terms against the debtor and third parties. It is prudent practice to ensure that the security agreement sets out events of default and the secured party's remedies in the event of default.

See Appendix 2 for a sample security agreement.

Debtors can offer virtually any property as security in commercial transactions:

- A company might give a lender a security interest in inventory and accounts receivable to secure repayment of a line of credit from the lender.
- A business might buy photocopiers on a "lease to own" basis whereby the vendor retains title to the photocopiers to ensure the lease payments are made.
- A purchaser who buys shares from the shareholder who is selling them, but is unable to pay the entire purchase price up front, could grant the seller a security interest in those shares, so the seller could recover them if the balance of the purchase price is not paid.
- A bank will often provide credit to a customer in exchange for the customer giving the bank security over everything the customer owns now or acquires in the future until the debt is repaid in full.

3. Kinds of Security

> *Property is either real property or personal property, and security may be either a "fixed" or a "floating" charge.*

Most property falls into two general categories: real property, which is land, and personal property, which is essentially all property that is not land or an interest in land. Either kind of property can be offered to a creditor as security.

This chapter focuses on security interests in personal property in British Columbia. The *Practice Material: Real Estate* deals with real property security (mortgages of land).

Security may be either a "fixed" or a "floating" charge. Under the *PPSA*, there is no need to distinguish between fixed and floating charges over personal property. However, a floating charge on real property could be subject to the *PPSA*.

(a) **Fixed Charge**

A fixed charge is a charge that exists on a specific *piece* of property (for example, a mortgage against specific land).

(b) **Floating Charge**

A floating charge is one that "floats" or "hovers" over a certain *category* of property (for example, all land owned by the debtor from time to time). A floating charge does not attach to that property until an event occurs (usually default by the debtor) that "crystallizes” the floating charge and causes it to become a fixed charge on the property.

An uncrystallized floating charge on land may be registered in the PPR, according to the *Land Title Act*, s. 203.

Two types of property do not fit nicely into the general categories of personal property or real property:

(a) **Fixtures**—personal property that becomes part of the land (for example, a boiler heater). See §3.07(11).

(b) **Property covered by other legislation or common law**—certain categories of property like liens, property dealt with by federal legislation, and certain assignments. See §3.10(3).

[§3.03] *PPSA*—Overview

1. Purpose of the *PPSA*

The PPSA *promotes uniformity and predictability — one set of rules for debtors and creditors — and creates a registry of charges.*

Many business transactions are financed through secured lending in various forms. A creditor who wants to take security from a debtor takes comfort in knowing that other creditors must follow the same rules. The creditor also wants to know whether the property the debtor is offering as security is already subject to a charge or security interest in favour of another secured party.

With real property, the creditor can search the title to the property at the Land Title Office. The title to land owned by the debtor will disclose the other parties who claim an interest in that land, whose charges will be registered. For personal property, the creditor’s task is not so simple.

The *PPSA* creates a notice system: the Personal Property Registry (“PPR”). Secured parties give notice of their security interests to other creditors by registering their interests. Lawyers conduct online PPR searches in order to advise clients whether other parties have filed financing statements giving notice of their interest in collateral. Registration and financing statements are discussed further in §3.06.

2. Substance Over Form

The PPSA *applies to every transaction and agreement that creates a security interest, regardless of the form of the agreement.*

Section 2 of the *PPSA* states that the Act applies to every transaction that in substance secures payment or performance of an obligation, without regard to its form and without regard to the person who has title to the collateral. The *PPSA* also applies to conditional sales, floating charges, pledges, assignments, consignments, leases (other than those of real property), trusts and transfers of chattel paper. It could also apply to agreements that might not appear to be security agreements, such as separation agreements or shareholders’ agreements, if they *in substance* create security interests.

Example: A tractor manufacturer sells a tractor to a farmer under a conditional sale agreement, which provides that the farmer will pay for the tractor in monthly installments over five years. The agreement provides that the sale of the tractor is conditional upon all payments being made by the farmer; until all payments are made, title to the tractor remains with the manufacturer. The manufacturer has security to protect against the farmer failing to pay. Accordingly, under s. 2 of the *PPSA*, the conditional sale agreement *in substance* secures the obligation to pay for the tractor, so is subject to the *PPSA*.

3. Deemed Security Interests

The Act deems certain transactions to create security interests, even though they do not secure payment or performance of an obligation.

Policy: *Some transactions between creditors and debtors might impair the debtor’s equity or title to collateral in ways that third-party creditors should be alerted to. For that reason, some transactions create deemed security interests.*

Section 3 of the *PPSA* states that (subject to ss. 4 and 55 of the Act), the *PPSA* applies to a transfer of an account or chattel paper, a commercial consignment, and a lease for a term of more than one year. These transactions would not fall within the general scope of the Act (as set out in s. 2), so under s. 3 they are *deemed* to be security agreements.

Since title to collateral does not determine any rights or obligations under the *PPSA*, some specific financing transactions can be misleading to third parties who are dealing with a debtor. For example, where a debtor has leased goods or is a consignee under a commercial consignment, third parties dealing with that debtor could reasonably think that the debtor owns those goods.

Issues with the deeming provisions of the *PPSA* usually arise with leases for a term of more than one year. Essentially, the definition includes leases that *could* extend for more than a year, but excludes leases where the lessor is not ordinarily in the business of leasing goods.

4. Scope of the *PPSA*

> *The* PPSA*, as a provincial statute, does not cover common-law liens and charges, or security interests under the Bank Act or other federal acts.*

Policy: *The* PPSA *does not apply where federal statutes govern security, due to the division of powers under the* Constitution *and the principle of paramountcy. The* PPSA *does not apply to interests in real property that are governed by a land registry system. Liens and other interests in personal property that arise at common law and under other statutes also fall outside the* PPSA.

The *PPSA* governs all transactions that *in substance* create a security interest in personal property under BC law.

Section 4 of the *PPSA* sets out creditors' interests that are not subject to the *PPSA*. These fall generally under the following categories:

(a) Non-contractual liens, such as those imposed by statute and common law. These include liens for unpaid wages under the *Employment Standards Act*, construction liens, and liens in favour of the Crown for unpaid taxes.

(b) Interests governed by federal legislation (for example, security under s. 427 of the *Bank Act* or security in ships under the *Canada Shipping Act, 2001*).

(c) Interests that arise in connection with land, including leases and rental payments.

(d) Certain assignments, such as assignments of wages or assignments in bankruptcy.

If the collateral includes investment property, consider the application of the *Securities Transfer Act* (*STA*). One of the purposes of the *STA* is to provide greater certainty with respect to the ownership and transfer of investment property, such as securities or shares that are traded on financial markets. The *STA* came into force in 2007. At that time the *PPSA* was amended (ss. 19.1 and 19.2) to include rules governing competing security interests in investment property.

Some types of security are subject to other BC laws, or even international law. For example, collateral that includes aircraft (whether fixed wing or helicopter) and aircraft engines may be subject to the *Convention on International Interests in Mobile Equipment* (the "Cape Town Convention") and the *Protocol to the Convention on International Interests in Mobile Equipment on Matters Specific to Aircraft Equipment* (the "Aircraft Protocol"). The Cape Town Convention and the Aircraft Protocol came into force in BC on April 1, 2013 under the *International Interests in Mobile Equipment (Aircraft Equipment) Act*, S.B.C. 2011, c. 12, which states that its provisions prevail in the event of any conflict between that Act and any other enactment (which would include the *PPSA*).

[§3.04] Attachment and Perfection

1. Attachment

> *A security interest is perfected when the* PPSA *requirements are met and it has "attached."*

Policy: *The aim of the* PPSA *to provide certainty is achieved, in part, by providing standard steps that a creditor can take to ensure that its security interest is effective.*

The concepts of "attachment" and "perfection" go hand in hand. Understanding them is necessary in order to understand how *priorities* are determined under the *PPSA*. Perfection matters when more than one creditor claims an interest in the debtor's collateral (see *PPSA* s. 10).

(a) Elements of Attachment

Attachment occurs when the security interest in a particular piece of collateral comes into existence. Without attachment, there is no security interest in the property.

Attachment determines the rights between the secured party and the debtor: if the security interest has not attached, the secured party has no security interest in the property and, therefore, cannot exercise remedy rights under the *PPSA*. Attachment also determines the rights of third parties: if the security interest has not attached, the debtor can transfer the debtor's interest in the collateral to a third party (for example, other secured parties, creditors of the debtor, or the debtor's trustee in bankruptcy).

Section 12 of the *PPSA* outlines the rules and requirements for attachment of security interests. Under s. 12(1), a security interest attaches to collateral when the secured party *gives value* to the debtor and the *debtor has rights in the collateral*. For prioritizing claims between the secured party and third parties, there is a further requirement for attachment—that the *security interest must be enforceable* under s. 10 of the *PPSA*.

These three elements of attachment are discussed in more detail below.

(i) Value Given

The value that the secured party may give is any consideration that would be sufficient to support any contract or agreement. Note that "value" is defined in s. 1 of the *PPSA*. In many cases, value is given when the loan is made, but the definition includes pre-existing debt or liability. Consequently, value can include a previously unsecured debt, or even the creditor refraining from taking steps to collect on an unsecured debt.

(ii) Debtor Has Rights in the Collateral

In order for a security interest granted by a debtor to attach to a piece of property, the debtor must have rights (ownership, a leasehold interest, possessory rights, or otherwise) in that collateral, or the power to transfer rights in that collateral to a third party. Put another way, a debtor cannot grant a security interest in collateral if the debtor has no interest in it.

The principle *nemo dat quod non habet* (one cannot give what one does not have) is discussed further in §3.07(2).

Subsections 12(2) and 12(3) of the *PPSA* prescribe specific situations in which the debtor is considered to have rights in collateral. Under s. 12(3), a debtor has no rights in crops until they become growing crops; the young of animals until they are conceived; minerals or hydrocarbons until they are extracted; or trees, other than crops, until they are severed.

As discussed in §3.02(3), a floating charge on personal property is treated as a fixed charge on the collateral of the debtor, pursuant to s. 2 of the *PPSA*. Accordingly, a floating charge effectively attaches to collateral as it comes into the debtor's possession.

(iii) Enforceable Security Interest

Pursuant to s. 10 of the *PPSA*, a security interest is enforceable against third parties if the secured party possesses the collateral or the debtor has signed a security agreement that contains an adequate description of the collateral charged. The *PPSA* requirements for an enforceable security interest are discussed in §3.05.

(b) Time of Attachment

Section 13 addresses the time of attachment of a security interest in after-acquired property. This section is intended to facilitate financing through inventory, accounts receivable and other forms of property that the debtor does not own when the security agreement is signed, but which the debtor will acquire in the future. The section provides that the security interest in after-acquired property attaches to that property in accordance with the terms of the security agreement, without any need for a specific appropriation by the debtor, subject to s. 12.

Example: A debtor signs a security agreement granting to a secured party a security interest in all present and after-acquired computer equipment. Assuming the security agreement is not discharged or released, if the debtor acquires computer equipment two years after the security agreement has been executed (and assuming the secured party had given value to the debtor as consideration), the security interest attaches to the computer equipment once the debtor acquires rights in the computer equipment. The secured party need not have the debtor execute a new security agreement granting a security interest in the newly acquired computer equipment.

Section 13(2) of the *PPSA* provides two specific exceptions with respect to attachment of security interests in after-acquired property.

First, s. 13(2)(a) provides that a security interest cannot attach to after-acquired property that is a crop where it becomes a growing crop more than one year after the security agreement has been made. This exception is a matter of policy, providing reprieve to farmers so that when they have a bad year their crops for future years are not subject to a pre-existing security.

Second, s. 13(2)(b) provides that a security interest cannot attach to after-acquired property that is consumer goods, unless the security interest is a purchase money security interest ("PMSI" is discussed in §3.07(4)) or is a security interest in replacement collateral.

2. Perfection

> *Perfection occurs when a secured party has taken all steps necessary to ensure that its security interest is effective to compete for priority with third parties, which also may have an interest in the collateral.*

A security interest may either be perfected or unperfected. When the security interest is perfected, the secured party enjoys priority rights under the *PPSA*. When a security interest is unperfected, the *PPSA* provides that, in most situations, the unperfected security interest will be subordinate to the interests of other persons who have an interest in the collateral. For example, see *Re Giffen*, [1998] 1 S.C.R. 91 and *Re Perimeter Transportation Ltd.*, 2009 BCSC 1458, affirmed 2010 BCCA 509.

If a security interest is not perfected, it ranks lower in priority (under *PPSA* s. 20) than claims by these parties:

- an unsecured creditor who has seized the collateral or obtained charging orders or equitable execution respecting the collateral;
- a sheriff who has seized or obtained a right to the collateral;
- a trustee in bankruptcy or the liquidator under the Winding-Up and Restructuring Act (Canada); and
- a bona fide transferee for value without knowledge of the prior security interest (if the collateral is a chattel paper, a document of title, an instrument, money, an intangible, or goods).

Section 19 of the *PPSA* provides that a security interest is perfected when (a) it has attached, and (b) all steps required for perfection under the Act have been completed, regardless of the order in which the steps occur.

A secured party may perfect an attached security interest in personal property by taking possession of the collateral, by registration of a financing statement in the PPR, or by "temporary perfection" (all discussed further below).

A security interest in personal property may be perfected in more than one way, depending on the kind of personal property. A security interest in a **good** may be perfected by registering a financing statement *and* by the secured party obtaining possession of the collateral. In most circumstances where the secured party takes possession of collateral to perfect a security interest, it is prudent for the secured party to also file a financing statement to perfect the security interest.

When the *STA* came into force, *PPSA* sections 19.1 and 19.2 were added to deal with perfecting security interests in securities accounts, futures accounts and investment property. For the purposes of perfection, it is always important to consider the special priority and perfection rules that apply to investment property.

Section 23 provides that no matter which way perfection has been achieved, the time of perfection will be the first date the security interest was perfected, if there was no intermediate period during which perfection lapsed.

(a) Perfection by Possession or Control—Sections 24 and 24.1

Pursuant to s. 24, the secured party (or the secured party's agent) may perfect many kinds of personal property by obtaining possession of the collateral. Chattel paper, goods, an instrument, a negotiable document of title, and money (all defined terms in s. 1 of the *PPSA*) may be perfected by possession of the collateral. Possession must be *actual* possession.

When the collateral is in the actual or apparent possession or control of the debtor or the debtor's agent, s. 24(2) provides that the secured party does not have possession of the collateral. This exception exists because third parties may be misled and reasonably believe that the collateral is not subject to a security interest perfected by possession if the collateral appears to be in the control or possession of the debtor.

If the secured party takes possession by seizure or repossession, the interest is not perfected under s. 24.

Again, the main **policy** behind ss. 24 and 24.1 is the general goal of predictability in the priority rules under the Act. The debtor must give possession (or control) voluntarily; otherwise, a secured party who simply forgets to register a financing statement to perfect a security interest could gain priority by seizing the collateral (i.e. an action usually reserved for after default). Actual possession is required to satisfy the requirement that third parties be able to see that the debtor has voluntarily given the secured party possession.

A security interest that has been perfected by possession will only remain perfected while the secured party possesses the collateral (subject to rules about temporary perfection in *PPSA* s. 26). If the secured party intends to return possession of the collateral to the debtor, the secured party should ensure that a financing statement has been filed in the PPR before returning the collateral to the debtor.

(b) Perfection by Registration—Section 25

Registration of a financing statement in the PPR is the most common method for perfecting a security interest in any kind of collateral. See §3.06 for more on registration.

However, for some kinds of collateral—for example, money, chattel paper, negotiable documents of title, and instruments—perfection by registration will not give the secured party the greatest protection available under the *PPSA*. Section 31 of the *PPSA* provides that a *bona fide* purchaser of these kinds of collateral will have priority over a security interest that is perfected by registration. Consequently, the secured party should perfect its security interest by taking possession (if possible) for those kinds of collateral.

It should be noted, however, that the *PPSA* does not limit the rights that a protected purchaser of a security has, or the priority of a prior security interest that a protected purchaser has, under the *STA* (s. 31.1).

The term "protected purchaser" is not defined in the *PPSA* but is defined in the *STA* to mean "a purchaser of a certificated or uncertificated security, or of an interest in the security, who (a) gives value, (b) does not have notice of any adverse claim to the security, and (c) obtains control of the security."

(c) Temporary Perfection—Sections 5 to 7.1, 26 and 29

The *PPSA* provides that a secured party's interest may be temporarily perfected in various situations. When a secured party appears to have an unperfected interest, the lawyer who acts for the secured party should be aware that the collateral may be subject to temporary perfection interests set out in *PPSA* ss. 5 to 7.1, 26 and 29.

Sections 5 to 7.1 of the *PPSA* set out certain periods when a secured party will be temporarily perfected if the collateral is moved outside British Columbia or the debtor is located outside British Columbia. The rules for determining the location of the debtor have recently changed; see §3.06(10).

Section 26 of the *PPSA* provides for temporary perfection if a secured party has perfected its security interest by possession and later returns the goods to the debtor.

Section 29 of the *PPSA* addresses a debtor selling goods subject to a security interest where the goods are later repossessed or returned to the debtor.

(d) Proceeds

"Proceeds" are defined in s. 1(1). Essentially, proceeds are identifiable and traceable personal property derived from any dealing with the collateral.

Under the *PPSA* s. 28, when collateral is sold, leased, or otherwise dealt with so that it gives rise to proceeds, a perfected security interest in the collateral continues in both the collateral and the proceeds, unless the secured party authorized the dealing.

Example: a secured party has a security interest in a wholesaler's inventory. When the inventory is sold, it gives rise to proceeds. The proceeds may take the form of money, goods (if the wholesaler accepted a trade-in), chattel paper (such as a conditional sale agreement) or other instruments. If the secured party authorized the dealing, then the security interest will be lost as against the original collateral, but it will attach to the proceeds. If a financing statement describing the proceeds in accordance with s. 28(2) has been registered, no other steps are necessary to perfect the security interest against the proceeds. However, if the proceeds have been perfected in any other way (that is, by possession or by temporary perfection), then the secured party has only a temporary perfection against the proceeds for 15 days after the collateral has been dealt with.

When a security interest is taken in collateral and perfected by registration of a financing statement, it is prudent to include the phrase "all proceeds, whether goods, investment property, instruments, documents of title, chattel paper, intangibles, money and licenses" in the description of collateral that appears in the financing statement. This ensures that if the original collateral is sold, the secured party's security interest in the proceeds will be perfected by registration.

[§3.05] Collateral Description

*To make a claim to a debtor's collateral, the secured party must have an **enforceable** security interest in collateral that is clearly **described**.*

The *PPSA* s. 10 sets out the criteria and protocol for establishing an enforceable security interest. For a security interest to be enforceable against a third party, the collateral either must be in the possession of the secured party (s. 10(1)(a)) or the debtor must have signed a security agreement containing specific descriptions.

The *PPSA* s. 10(1)(d) sets out four basic ways to describe the collateral:

(i) By item or kind: the collateral can be described either as a specific item (for example, a red 2002 "Lance Armstrong Edition" Trek road bike) or by kind (all present and after-acquired bikes).

(ii) By one of the following categories: goods, investment property, instruments, documents of title, chattel paper, intangibles, money, crops or licences (all of which are defined terms in s. 1 of the *PPSA*).

(iii) All PAAP: if the secured party wants to take a security interest in **all** of the personal property of the debtor, present or future, then the security agreement must state that a security interest is taken in "all of the debtor's present and after-acquired personal property" (generally referred to as "**All PAAP**").

(iv) All PAAP "except": the security agreement can be for All PAAP with a "carve-out": it can provide that the secured party will take a security interest in all of the debtor's present and future property *except* property described by item or kind, or referred to by one of the categories set out in (b) above.

It is not necessary to include serial numbers in descriptions of general collateral in the security agreement. Some goods, however, are identified in the Regulation as "serial numbered goods" and their serial numbers must be registered (*PPSA* s. 35(4)). Serial numbered goods include motor vehicles, manufactured homes, trailers, boats, aircraft and outboard motors. (See §3.06(3)(c) below for more on serial numbered goods.)

In addition to properly describing the collateral, the security agreement must specify what obligations are secured by the security interest. The description of the obligations secured will depend on the transaction. The description of obligations secured can be either general or specific. For example:

General—All past, present and future obligations of the debtor to the secured party.

Specific—All obligations of the debtor to the secured party pursuant to a specified agreement, promissory note, guarantee, etc.

[§3.06] Registration

The Personal Property Registry ("PPR") is a notice system; it does not create or validate a security interest.

1. Perfection by Registration

As noted in §3.04(2), a secured party may perfect a security interest by registration (s. 25). Of the three methods of perfection, registration is the only one that may be used for all kinds of collateral.

To perfect by registration, the secured party must file a financing statement in the PPR. The PPR is a computerized notice registry for registration of all charges against personal property (other than certain charges governed by federal law, such as *Bank Act* s. 427 security (see §3.07(10)), or mortgages on ships).

The forms and technical procedures for registering in the PPR are set out in the *PPSA* and the Personal Property Regulation. General procedures are described in the "Personal Property Registry System User's Guide" available from BC OnLine: www.bconline.gov.bc.ca/pdf/personal_prop.pdf.

The following are some key features of the PPR system.

2. Notice System

The PPR is simply a notice system. Registration in the PPR does not create a security interest, nor does it determine whether a creditor has valid security. A creditor may register an electronic financing statement, which simply gives notice that the secured party may have a security interest in a debtor's personal property (as described).

Only financing statements and financing change statements (and court orders) may be filed in the PPR: the secured creditor does not register a copy of its security agreement.

While a financing statement filed in the PPR is used to perfect (by registration) a security interest under the *PPSA*, the PPR is also used to register liens under a number of provincial statutes, such as the *Family Law Act*, *Land Tax Deferment Act*, *Manufactured Home Act*, *Miscellaneous Registrations Act* and *Repairers Lien Act*.

3. Elements of a Financing Statement

A financing statement is an online form. It is filed online by being completed and submitted for registration.

A financing statement must include the name and address of the secured party, the name and address of the debtor, the term of registration, and a description of the collateral. Remember that the PPR serves as a notice registry. Consequently, a secured party must be accurate in the descriptions provided for each field so that those searching the system have the best chance to obtain accurate information (see §3.06(6)). The secured party should take care to provide accurate information.

(a) **Secured Party**

A financing statement must contain the secured party's current name and address so that it is clear who is registering the security interest. This information is also necessary because other creditors are entitled to demand to inspect the security agreement pursuant to s. 18 of the *PPSA*.

(b) **Debtor**

The debtor's name must be accurately spelled and complete. The Personal Property Regulation provides specific rules and requirements for setting out the debtor's name when the debtor is a corporation, partnership, trust, individual, etc. It is important to review the Regulation before filing a financing statement. One common rule is commonly overlooked: Section 8(5) of the Personal Property Regulation provides that when the debtor is a corporation and the name of the corporation is spelled at least two ways using English and French, or a combination of the two, all spellings of the debtor's name must be entered separately. To satisfy this rule, some practitioners include these separate debtor names in the financing statement: (i) English, (ii) French, (iii) English/French and (iv) French/English. Others use the combined name exactly as it appears in the corporation's constating documents.

Prior to January 25, 2022, there were restrictions under the Personal Property Regulation against the entering of commas, periods, and certain other punctuations in the name of certain debtors (including business debtors). However, these restrictions were removed effective January 25, 2022 and punctuation may be entered in the name of a debtor.

(c) **Collateral Description**

It is important to consider ss. 10, 30 and 35 of the *PPSA* together with ss. 1(1) and 9 to 11 of the Regulation when completing a financing statement. Combined, these provisions provide the best base for ensuring that the financing statement contains accurate and complete information about the type of collateral.

On a financing statement, there are two "data fields" where information regarding the collateral charged may be entered: the general collateral description, and the serial number description.

(i) General collateral

A description of general collateral in a financing statement that does not refer to the item or "kind" of collateral is inadequate (s. 10 of the *PPSA* and ss. 9 to 11 of the Regulation). "Kinds" of collateral are goods, investment property, instruments, documents of title, chattel paper, intangibles, money, crops or licences. Note that the term "equipment" is not a kind, and is inadequate for a collateral description without further reference to the kind of collateral.

(ii) Serial numbered goods

All goods under the *PPSA* are classified as *consumer goods*, *inventory* or *equipment*. The *PPSA* provides that some types of goods, in certain circumstances, *must* be described by the serial number in the financing statement that is registered in the PPR. These are "serial numbered goods."

"Serial numbered goods" are defined in the Regulation (s. 1(1)) as motor vehicles, manufactured homes, boats, outboard motors, trailers and aircraft. While other types of goods may have serial numbers, only goods in the defined list are "serial numbered goods" for the purposes of the *PPSA*. Descriptions of these goods must include serial numbers in the separate data field on the financing statement. This is significant to searchers because serial numbered goods are searchable by serial number, while general collateral is not (see s. 48 of the *PPSA*).

When the collateral is consumer goods that are serial numbered goods, s. 9(1)(a) of the Personal Property Regulation requires the registering party to describe the collateral by serial numbers. When the debtor holds serial numbered goods as equipment, the registering party must describe the goods using the serial number if the party is to have priority in the following situations:

- over a buyer without notice of the security interest (*PPSA* s. 30(6) and (7)); and
- over other secured creditors pursuant to the residual priority rule in s. 35 of the *PPSA* (see discussion in §3.07(3)).

When the debtor holds goods that have serial numbers as inventory, the registering party should not register against serial numbered goods.

(d) **Term**

When registering, the registering party selects the period of registration—from one to 25 years, or for perpetuity. Cost varies according to the period of registration.

4. Timing of Registration—Before Attachment

> *A secured party can register notice of its security interest before the security interest attaches and even before it has been granted.*

Section 43 of the *PPSA* allows a secured party to file a financing statement against a debtor before a security agreement has been signed and before the security interest attaches. Since the general priority rule (see discussion in §3.07) is that the secured party with the earliest registration has priority, it is advantageous for a secured party to register a financing statement as soon the secured party knows that the debtor intends to grant it a security interest.

5. Amendments to Existing Registrations

Financing change statements are used to make changes to an existing financing statement.

A secured party files a financing change statement to modify, amend, renew or discharge the existing registration, such as when the debtor changes its name (*PPSA* s. 51), the debtor transfers its collateral to a third party (*PPSA* s. 51), the secured party transfers its interest (*PPSA* s. 45), or the registration is about to expire (*PPSA* s. 44(2)). The procedure and requirements for a financing change statement are as rigid as they are for a financing statement, so the secured party should ensure that it complies precisely with the *PPSA* (ss. 44(2), 45, 50 and 51) and the Personal Property Regulation (Part 3 and Part 4) when filing a financing change statement.

6. Misleading Information

The information on a financing statement or a financing change statement must be clear, accurate and complete. There has been a great deal of litigation over faulty registrations in the PPR.

Section 43(6) of the *PPSA* provides that the validity of the registration of a financing statement is not affected by a defect, irregularity, omission or error in the financing statement or in the registration of it unless the defect, irregularity, omission or error is seriously misleading. The test for whether the defect is "seriously misleading" is an objective test: pursuant to s. 43(8), it is not necessary to prove that anyone was actually misled by the defect. The *PPSA* does not set out what defects are seriously misleading. Several cases consider this issue.

The decision of the Supreme Court of British Columbia in *Alda Wholesale Ltd. (Trustee in Bankruptcy)*, 2001 BCSC 921 has imposed stricter requirements on collateral descriptions. *Alda* says that registrations that do not include "after-acquired" language only perfect security interests that have attached as of the date the financing statement is registered. *Alda* is also authority that *any* defect in a financing statement may invalidate a registration, if it would mislead a reasonable searcher.

7. Section 18 Demands

Parties with an interest in the collateral may request a copy of the security agreement to which a financing statement relates.

The financing statement does not refer to the security agreement, and it does not disclose the amount outstanding to the secured party. Interested parties may request this information from the secured party. Section 18 of the *PPSA* imposes an obligation upon the secured party to provide the debtor and any other person who has an interest in the collateral with a copy of the security agreement and other relevant information, within 10 days of demand.

8. Removing Invalid Registration

Since the *PPSA* allows anyone to file a financing statement against any name, the *PPSA* also permits a debtor named in a financing statement to dispute that the secured party in the financing statement is entitled to the registration. Section 50 of the *PPSA* sets out the process under which a debtor may have a financing statement removed or amended where the secured party does not have a valid security interest in the debtor's collateral or the registration is overly broad.

9. Registration Not Knowledge

Note that while the PPR is a notice system, s. 47 of the *PPSA* provides that registration of a financing statement does not by itself mean that parties know what has been filed. Registration does not constitute express, constructive or implied notice to any person of the financing statement or the security agreement.

Many rules in the *PPSA* that give priority to innocent purchasers consider whether the purchaser had actual knowledge of a security interest. For the purposes of those sections, the registration of a financing statement is not deemed to be notice or knowledge of a security interest.

10. Jurisdiction

Generally, a secured party must perfect in the jurisdiction in which the collateral is located. There are exceptions, including for intangibles and mobile goods.

Sections 5 to 8 of the *PPSA* deal with conflicts of laws and jurisdictional issues. Generally, the law governing a security interest is the law of the jurisdiction where the collateral is located at the time the security interest attaches.

However, different rules apply when the collateral is an intangible or a mobile good (basically, a good used in more than one jurisdiction). Under s. 7, the law that applies in this case is the law of the jurisdiction where the debtor was located at the time that the security interest attached. The location of the debtor depends on the type of debtor. These rules are summarized in the following table.

Summary of Debtor Location Rules	
Type of debtor	**Location of debtor**
Individual	The debtor's location is where the individual's principal residence is located.
Partnership (other than a limited partnership)	The debtor's location is the province whose laws govern the partnership, according to the partnership agreement.
Limited partnership	The debtor's location is the province the limited partnership was created in.
Provincially incorporated company	The debtor's location is the province the corporation was incorporated in.
Other organization that is organized under the laws of a province and whose organization must be disclosed in a public record	The debtor's location is the province the organization was organized in.
Federally incorporated corporation	The debtor's location is in the jurisdiction where the registered office or head office is located, (i) as stated in the constating instrument under which the debtor was incorporated, continued, or amalgamated; or, if that does not apply, then (ii) in the debtor's bylaws.
Trustee acting for a trust	The debtor's location is (i) the province that the trust instrument states the trust is governed by, or, if that does not apply, then (ii) in the jurisdiction where the trustee principally carries out the administration of the trust.
If none of the above apply	The debtor's location is the jurisdiction where its chief executive officer is located.

11. Searches

Searches are conducted online, either by debtor name or by serial number.

If the registering party made an error when recording the name or serial number in the financing statement, and then the searcher conducts a search only by the correct name or serial number, the search results will indicate that there are no exact matches. The defective registration may show up as a close or inexact match. It is prudent, therefore, to search the correct legal name of the debtor as well as any trade names the debtor commonly uses. It is also necessary to select, print and review results that are noted to be exact but also those noted as close matches to the debtor's name or the serial number.

PPR search results will not indicate or absolutely determine priorities. Since the *PPSA* provides for many priority rules, the order in which secured parties appear on the PPR search result does not necessarily indicate which secured party has priority.

[§3.07] Priorities

1. *PPSA* Determines Priorities

> *The* PPSA *provides a set of rules to determine the ranking, or priority, of claims of creditors who have security interests in the same collateral.*

Once the secured party has registered notice of its security interest by filing a financing statement in the PPR, the lawyer must ensure that, to the extent possible, the secured party will have priority to the collateral if the debtor defaults. Most litigation under the *PPSA* involves disputes between secured parties over priority to certain collateral. The general rule is that a secured party who has a security agreement with the debtor and gives notice of that security interest by filing a financing statement will have priority over competing secured parties who file financing statements later. However, the "first to file" principle is a general rule only, and there are a number of important exceptions to it that frequently apply in commercial transactions.

A debtor will often grant a security interest in the same collateral to more than one secured party to secure more than one obligation. If the debtor defaults on its obligations, the secured parties will all want to realize on their security to recover the amounts owing to them. In addition, there may be other creditors of the debtor who are unsecured (for example, judgment holders and unsecured lenders) or who have a lien on the collateral.

The *PPSA* sets out rules for determining the ranking of each secured party who has a security interest that is governed by the *PPSA*, as well as special cases (such as bailees).

If a creditor asserts priority based upon a lien under a provincial statute, it will be necessary to refer to the provincial statute in question and the jurisprudence to determine priority.

There are many priority rules under the *PPSA*, with several exceptions to each rule. However, one common approach is first to determine whether any special priority rule applies in the circumstances; if not, the residual priority rules of s. 35 apply.

2. *Nemo Dat Quod Non Habet*

> *A debtor cannot give a secured party a greater interest in the collateral than the debtor has.*

The rule of *nemo dat quod non habet* means that one cannot give more than one has, or a debtor cannot give a greater interest in the collateral than the debtor has. Where a secured party takes a security interest in collateral that is already subject to a charge that is outside the scope of the *PPSA* (s. 4), the rule will apply and subordinate the *PPSA* security interest to the other security. For example, where collateral is charged by a lien granted under the *Builders Lien Act*, and the *PPSA* security interest attaches to the collateral *after* the builder's lien, the lien security will have priority over the *PPSA* security.

3. Residual Priority Rule—Section 35

The residual priority rule (the general rule applied where no special priority rule applies) is set out in s. 35 of the *PPSA*, as follows:

- Between two perfected security interests, priority goes to the secured party who is the first to register a financing statement, to perfect its security interest by possession or delivery under s. 24, or to temporarily perfect.
- A perfected security interest has priority over an unperfected security interest.
- Between two unperfected security interests, priority goes to the first security interest to attach to the collateral.

The residual priority rule will apply only if no other rule for determining priorities under the *PPSA* applies. (The residual priority rules under s. 35 do not apply to collateral that is investment property. Instead, conflicting interests in collateral that is investment property are governed by the priority rules set out in s. 35.1 of the *PPSA*.) Since title is not determinative of priority, a secured party with the first correctly perfected security interest in the collateral may enjoy priority over another party who actually owns the collateral.

4. Purchase Money Security Interests—Section 34

The *PPSA* creates a special type of security interest called a purchase money security interest ("PMSI") (s. 1(1)). A PMSI is created when a secured party provides the credit or financing that allows the debtor to acquire the collateral.

A PMSI also includes the interest of a lessor of goods under a lease for a term of more than one year and the interest of a consignor under a commercial consignment.

A PMSI cannot be taken in investment property.

Policy: *The PMSI enables a debtor to acquire new collateral where the debtor has existing debt. The debtor who has given a security agreement that contains an after-acquired property clause would likely be unable to obtain further financing without this "super-priority" rule. Lenders would not provide further financing, knowing they would rank after the existing creditor. Furthermore, the prior secured party that has a general security interest was not relying on this new collateral when it extended credit secured by the previous collateral and, therefore, is not misled or disadvantaged by the rule.*

Note that no special language (other than the simple grant of a security interest) is necessary to create a PMSI. A PMSI arises when the secured party's security interest meets the definition in the *PPSA*.

The *PPSA* provides a super-priority to a secured party with a PMSI *if* the secured party complies with the requirements in s. 34 of the *PPSA*. A PMSI has priority over any other security interest in the same collateral granted by the same debtor in all of the following circumstances:

- The security interest in the collateral (other than inventory or intangibles) is perfected within 15 days of the debtor obtaining possession of the collateral (s. 34(1)(a)).
- The collateral is intangibles, and the security interest is perfected within 15 days of the security interest attaching to the intangible (because intangibles are not capable of being possessed) (s. 34(1)(b)).
- The collateral is inventory, the security interest is perfected on or before the date the debtor obtains possession of the inventory, *and* the secured party gives notice of the PMSI in the inventory to all other secured parties who have previously registered a financing statement

containing a description of the same item or kind of collateral.

There are a few important issues to note in respect of PMSIs:

(a) In order for a secured party to have a PMSI, the secured party must have evidence to show that the secured party financed the collateral.

(b) A PMSI (and the super-priority created thereby) only extends to the financed portion of the collateral. If only $1,000 of the financing supplied by the secured party was actually applied towards the debtor acquiring rights in the collateral, the secured party will only have a PMSI for $1,000.

(c) Where two PMSIs exist in the same collateral granted by the same debtor, s. 34(4) of the *PPSA* provides that the seller, lessor, or consignor has priority over the other PMSI. (The other PMSI holder may be, for example, a financier who supplied the down payment on the collateral.) (Note that a policy decision was made to create certainty by favouring the supplier of the collateral.)

(d) A PMSI only has priority over security interests in the same collateral granted by the *same* debtor.

Section 34 includes additional rules for PMSIs in proceeds, including giving priority to PMSIs that finance new value over PMSIs that financed inventory since turned into proceeds. This section of the *PPSA* also gives super-priority to secured parties that provide new value to the debtor for the purpose of raising livestock or growing crops.

5. Buyers and Lessees of Goods—Section 30

A buyer or lessee of goods sold or leased in the ordinary course of the seller or lessor's business has priority over any security interest (perfected or unperfected) granted by the seller or lessor, unless the buyer or lessee knows that the sale or lease is a breach of the security agreement (s. 30(2)).

Section 30(3) provides protection to a purchaser of consumer goods who has no knowledge of a security interest when the market value of the consumer good is less than $1,500. The sale under s. 30(3) does not have to be in the ordinary course of business of the seller.

Policy: Bona fide *purchasers need to be protected when they purchase collateral in the ordinary course of business.*

6. Transferees of Negotiable Collateral—Section 31

For negotiable (and quasi-negotiable collateral) such as money, instruments, securities, chattel paper, and negotiable documents of title, s. 31 of the *PPSA* provides that a *bona fide* purchaser of these kinds of collateral who takes possession of the collateral will have priority over security interests that are not perfected by possession. Essentially, for a secured party to obtain the highest degree of priority over these kinds of collateral, it is necessary to perfect its security interest by taking possession. As noted earlier, nothing in the *PPSA* limits the rights or prior security interest that a protected purchaser of a security has under the *STA*.

Policy: *These kinds of collateral are negotiable, and innocent third-party transferees should be able to rely on receiving possession of the collateral.*

7. Lien Holders—Section 32

Section 32 of the *PPSA* provides that a lien on goods that arises due to provision of materials or services in respect of the goods (e.g. a repairer's lien) has priority over a perfected or unperfected security interest in the goods, unless the statute provides otherwise. It is important to review the statute creating the lien to determine whether it indicates that the lien is subordinate to the security interest.

Policy: *The materials and services the lien holder provides increase the value of the collateral. If the secured party were to have priority, the secured party would obtain an unfair windfall.*

Section 32 of the *PPSA* is an exception to the general rule in s. 4(a), which provides that the *PPSA* does not apply to a lien, charge or other interest given by a rule of law or by another statute.

8. Subordination Agreements—Section 40

Section 40 permits a secured party to contractually subordinate its security interest to any other interests. The agreement to subordinate may be in the security agreement itself or in another agreement. Section 40 alters the common law by allowing a third party to take the benefit of the subordination (even where the third party is not a party to the agreement), if the third party is the person or one of the class of persons for whose benefit the subordination was intended. A subordination agreement may be registered under s. 45(6), although it will be effective even if it is not registered. A subordination or postponement agreement does not create a security interest by virtue of the subordination or postponement alone (s. 40(2)).

9. Other Priority Rules—Sections 29, 36, 37, 38, 39

The *PPSA* also provides special priority rules for fixtures (s. 36) (see §3.07(11) below), crops (s. 37), accessions (s. 38), processed or commingled goods (s. 39) and returned or repossessed goods (s. 29). It is important to review these sections when dealing with these types of collateral or collateral in these types of situations.

Under the *PPSA*, crops are treated as personal property even though they are still growing and therefore attached to land: see the definition of "crops" in s. 1(1). The priority rules with respect to crops contained in s. 37 parallel the rules with respect to fixtures (s. 36).

In s. 1(1) "accessions" are defined as goods that are installed in or affixed to other goods. At common law, accessions became part of the whole and, as such, ownership vests in the owner of the whole. By contrast, s. 38 permits the preservation of a security interest in goods after they have become accessions. Section 38 recognizes the ability to take a security interest in goods attached to other goods.

Section 38 treats security interests in accessions in the same way that s. 36 treats security interests in fixtures, except that there are no additional registration requirements (as there are with fixtures).

Section 39 applies when goods, such as raw materials or ingredients, are combined into one product so that their identity is lost in the product. Where two separate quantities of goods, each subject to a security interest held by two different secured parties, are commingled so as to produce a new product, the secured parties lose their security interest in the original goods but are given a prorated statutory security interest in the end product.

10. *Bank Act* Security

> Bank Act *security can only be taken by chartered banks and in certain types of collateral; it effectively transfers title in the collateral to the bank.*

Section 427 of the federal *Bank Act* permits a company to charge, among other things, its inventory and manufacturing equipment in favour of a chartered bank. When you are acting for a creditor who proposes to take security from a party that borrows money from a bank (for greater certainty, not including provincial credit unions), it is important to conduct a *Bank Act* search of the debtor's name and all predecessor names of the debtor. When you are acting for a bank lender, it is common for the bank to require *Bank Act* security from its corporate borrowers.

Bank Act security (often referred to as s. 427 security) involves a transfer of legal title in the currently owned collateral, and an equitable assignment of the future collateral. Title vests in the bank, and the bank may take possession of and sell the goods. The rights of the bank are void as against other creditors and subsequent *bona fide* purchasers of the collateral, unless a notice of intention has been filed with the Bank of Canada before the security is granted (but not more than three years before).

Bank Act security has limited utility in British Columbia since the enactment of the *PPSA*, as it gives the bank very few rights that it could not obtain by taking regular *PPSA* security. There is one area, however, in which *Bank Act* security can be very useful to a bank—in a priority dispute with a distraining landlord. A landlord has the right to distrain for arrears of rent against a tenant's property. The landlord's right of distraint takes priority over secured parties (other than PMSI holders) who have an interest in the tenant's goods, so long as the goods are located on the leased premises. However, if the tenant's collateral is subject to *Bank Act* security, the bank will defeat the landlord's right of distraint, because title to the collateral has legally passed to the bank and is therefore not property of the debtor upon which the landlord can distrain.

11. Fixtures

> *Fixtures are personal property that has become affixed to real property. Whether something is a fixture is determined at common law.*

A fixture is personal property that becomes affixed to real property. The *PPSA* does not define "fixture" except to say that a fixture does *not* include building materials. Accordingly, the common law tests for determining whether collateral is a fixture are relevant. See *Northwest Trust Co. v. Rezyn Developments Inc.*, 1991 CanLII 939 (B.C.C.A.); *La Salle Recreations Ltd. v. Canadian Camdex Investments Ltd.*, 1969 CanLII 740 (B.C.C.A.).

The *PPSA* provides specific rules governing security interests in fixtures. The rules determine whose claim to the fixtures has priority in various circumstances. Generally, a person whose claim attached to the personal property before it was affixed has priority before a person with a claim in the land, subject to the rules under *PPSA* s. 36.

Section 49 provides the procedure and form for filing a Fixtures Notice against title to the real property. Where a secured party takes a security interest in a good that becomes a fixture, a Fixtures Notice should be filed against title to the land to ensure the secured party maintains its priority to the fixture.

[§3.08] Enforcing Security Interests

1. *PPSA* Part 5

Part 5 of the PPSA *governs the rights and remedies of the secured party and the debtor upon default by the debtor.*

Most security agreements contain a provision itemizing the various things that will constitute a default, triggering the secured party's rights to enforce its security interests. The usual event of default is when the debtor fails to pay or perform its obligations. Other common events of default include bankruptcy, receivership, or insolvency of the debtor, a material adverse change in the debtor's financial situation, another creditor commencing enforcement proceedings against the debtor, or a judgment being issued against the debtor.

Part 5 of the *PPSA* provides a range of usual remedies for secured parties, and deems those remedies to become available if a debtor defaults. Therefore, neither default nor remedy sections are technically required in a security agreement.

There are some general principles to keep in mind when considering the secured party's options under Part 5:

(a) Section 56 makes Part 5 of the *PPSA* a complete "code" for enforcing security interests. The enforcement rules may only be modified to the extent allowed in Part 5. A secured party's rights and remedies against a debtor are limited to the rights provided in the security agreement, the rights and remedies in Part 5, rights of removal of fixtures (ss. 36(6) and (7)) and rights to seize and dispose of crops (s. 37) and accessions (s. 38).

(b) The secured party's rights and remedies are all subject to the requirement in s. 68(2) that they be exercised in good faith and in a commercially reasonable manner.

(c) With a few exceptions, debtors cannot waive or vary any of their rights under Part 5 until after default. After default, debtors may, in writing, waive their rights under s. 59 to

- notice of disposition of the collateral by the secured party, and
- the right to redeem the collateral by paying the obligation secured.

(d) Sections 63 and 70 of the *PPSA* deal with the supervisory jurisdiction of the court in situations where a secured party is enforcing its security agreement. If there is any dispute over the timing or manner of enforcement, the court has broad powers to make directions regarding the exercise of Part 5 remedies and rights, and may relieve parties from compliance with Part 5 if it would be just and reasonable to do so.

(e) When the same obligation is secured by an interest in land and a security interest under the *PPSA*, the secured party can choose to proceed with enforcement under the *PPSA* with respect to the personal property, or proceed against both the personal property and the land as if the personal property were land. This is why, in real property foreclosure proceedings, a mortgagee might foreclose on land and personal property at the same time.

2. Contractual Rights—Section 58

The secured party may seize or repossess goods by any method permitted by law, unless the security agreement otherwise provides.

Part 5 does not apply to agreements that do not *in substance* create a security interest (that is, s. 3 security interests that do not secure payment or performance, including a lease for a term of more than one year and a commercial consignment). Where Part 5 does not apply, creditors' rights must be contained in the contract governing the lease or consignment.

The debtor and secured party may agree in the security agreement on their respective rights and remedies on default. Unless otherwise agreed, the secured party may enforce the security agreement by any method permitted by law, unless:

- the collateral is fixtures, crops, or accessions, in which case ss. 36 to 38 of the Act must be followed; or
- the collateral is consumer goods and the debtor has paid at least 2/3 of the obligation secured (s. 58(3), and see §3.08(8)).

3. Sale of Seized Collateral—Section 59

The secured party may dispose of collateral after giving 20 days' notice to specific parties.

Policy: *Before a secured party disposes of collateral, other parties with interests in the collateral that will be extinguished by the disposition need to have notice, so that they can take steps (if necessary) to protect their interests.*

A secured party may dispose of collateral by public or private sale, either as a whole or in parts. If the security agreement permits it, the collateral may also be disposed of by lease. The secured party's reasonable costs of seizing and disposing of the collateral may be deducted from the proceeds of disposition, before applying the proceeds to the obligation secured.

The secured party must give at least 20 days' written notice of disposition to the debtor, anyone else known by the secured party to have an interest in the collateral, any subordinate secured parties who have registered a financing statement, and anyone who gives the secured party notice of an interest in the collateral before the notice of disposition is sent.

Sections 59(7) and 59(8) set out what must be in the notice of disposition, including the amount owed to the secured party. Anyone who receives the notice of disposition can redeem the collateral by paying this amount, often called the "redemption amount" (see §3.08(6) below). A party who pays it steps into the shoes of the enforcing secured party.

In some circumstances the notice of disposition is not required (s. 59(17)). Notice of disposition is not given to secured creditors with priority over the secured party's security interest because the collateral will be sold *subject to* those security interests.

4. Payment of Sale Proceeds—Section 60

Any surplus must be paid to other perfected secured creditors before the debtor can receive any of the surplus money.

Although it is unusual, sometimes there is surplus money remaining after the secured party has disposed of the collateral and applied the proceeds to the outstanding obligations. If there is a surplus, the secured party must first pay it to subordinate secured parties whose security interests were perfected by registration or possession at the time the collateral was seized. If there is still money left, the surplus must be paid to persons who have given notice to the secured party of an interest in the collateral. Once these parties are paid, the remaining surplus, if any, may be given to the debtor.

Section 60(4) allows the secured party to pay any surplus into court if there is a question as to who is entitled to it. A secured creditor will usually take this step if there is any concern that the funds might be paid to the wrong party: a secured party will want to avoid attracting possible liability for giving the money to the wrong person. Once surplus funds have been paid into court, they can only be released upon the summary application of a person claiming entitlement to them.

5. Voluntary Foreclosure—Section 61

If the collateral is worth less than the obligation secured, a secured party may wish to conduct a voluntary foreclosure, in which the collateral is taken in full satisfaction of the obligations.

Sometimes, after the debtor defaults, it becomes clear that the collateral is worth much less than the obligations secured, or there is no ready market for the collateral, or the secured party wants to keep the collateral. In these cases, the secured party can give notice (to everyone entitled to notice of disposition under s. 59) of its intention to retain the collateral in full satisfaction of the secured obligations.

The debtor may, of course, disagree that the collateral is worth less than the debt, and may even suspect that the secured party is trying to "scoop" a valuable asset. Accordingly, the debtor, or any other party who receives notice of a voluntary foreclosure, has 15 days to deliver a notice of objection to the secured party, in which case the secured party *must* dispose of the collateral under s. 59.

This procedure ensures that the debtor and other interested parties will be able to recover the surplus, if any, after sale of the collateral. If the secured party really does believe that the collateral will not bring enough at sale to satisfy the obligations secured, it may apply to court for a determination that the notice of objection was improper or unwarranted.

6. Redemption and Reinstatement—Section 62

After default, the debtor can (in certain circumstances) reinstate the security agreement, and any party who receives a s. 59 notice of disposition can redeem the collateral.

If a secured party has taken steps to realize on the collateral, either by sending a s. 59 notice of disposition or a s. 61 voluntary foreclosure notice, every party who receives that notice can "redeem" the collateral by paying the obligation secured, plus the reasonable expenses of the secured party in seizing and preparing the collateral for disposition.

The amount that must be paid to redeem the collateral (usually called the "redemption amount") is set out in the notice of disposition. "Redeeming" the collateral means that the collateral is freed from the secured party's security interest, and remains in the hands of the debtor, subject to other parties' continuing interests in that collateral.

If the collateral is consumer goods, s. 62 provides that the debtor may reinstate the security agreement by paying all amounts actually in arrears (not including any accelerated amounts), plus the secured party's reasonable expenses.

7. Receivers—Section 64

> *A secured party may appoint a receiver to enforce the security agreement and dispose of the collateral.*

Most security agreements, in their provisions dealing with the secured party's rights on default by the debtor, provide for the appointment of a receiver. If a receiver is appointed under a security agreement, this is called a "private appointment" or "instrument appointment"; s. 64(1) requires that any such receiver be a licensed trustee in bankruptcy under the *Bankruptcy and Insolvency Act* (Canada).

Section 64(2) sets out the qualifications for "court-appointed receivers" (who do not need to be bankruptcy trustees). There are a number of reasons why court-appointed receivers are often used instead of instrument-appointed receivers. Sometimes a security agreement does not provide for the appointment of a receiver; sometimes the debtor is uncooperative and refuses to allow an instrument-appointed receiver to have access to the collateral; sometimes there is no licensed bankruptcy trustee available; and sometimes the secured party simply wishes to have a receiver put in place pursuant to a court order. It is more expensive to put a court-appointed receiver in place, so in acting for a secured party, use an instrument appointment where possible.

Section 65 contains a number of reporting and accounting requirements for receivers. Section 66 provides various court remedies relating to receiverships, including the appointment, removal or replacement of a receiver, directions as to the duties of the receiver, approval of the receiver's fees and accounts, and so on. You should read these sections carefully if you are acting for a receiver or a secured party who has appointed a receiver.

Most of the provisions of Part 5 apply to receivers in the same way that they apply to secured parties.

8. Consumer Goods—Special Enforcement Rules—Section 67

> *In the case of consumer goods, a secured party must either seize the collateral or sue the debtor. The secured party cannot do both.*

Policy: *As between consumers and secured parties, secured parties are presumed to be more sophisticated and to know enough to beware of lending where the value of the collateral will not cover the debt and interest.*

Parties to a security agreement enjoy freedom of contract, subject to certain limitations in the *PPSA* that are designed to protect vulnerable parties in commercial transactions. One such limitation was mentioned earlier (§3.08(2)): s. 58(3) of the *PPSA* says that, if at least 2/3 of a debt for consumer goods has been paid, those goods are not subject to seizure. Another of those limitations is found in s. 67, which deals with enforcement of security agreements involving consumer goods.

A secured party who is entitled to seize consumer goods must make a choice with respect to its remedies. The secured party may bring an action for judgment against the debtor for the amount of obligation secured; alternatively, the secured party may enforce its interest in the collateral by seizure (s. 58), possession (s. 61) or surrender of the collateral by the debtor. This choice of remedies in dealing with consumer goods is usually referred to as "seize or sue."

If the secured party seizes or accepts surrender of the collateral, the debtor's obligations under the security agreement are extinguished, even if the collateral is worth less than the obligation secured. (The obligations of a guarantor or indemnitor of the debtor's obligations are also extinguished.) If the secured party elects not to proceed against the collateral, but seeks judgment instead, then the security interest in the consumer goods is extinguished and the secured party must discharge any registration relating to the security interest within one month.

In acting for a client who seeks to enforce a security agreement involving consumer goods, review the exceptions to the "seize or sue" rule carefully. There are three important exceptions:

(a) the consumer protection provisions do not apply if the debtor is a company, partnership or joint venture;

(b) the obligations of the debtor and guarantor are revived if the seized consumer goods are returned to the debtor within 20 days; and

(c) if the debtor has engaged in wilful or reckless acts or neglect that caused substantial damage or deterioration to the goods, the secured party may obtain a court order that some or all of the rights or remedies in s. 67 do not apply.

[§3.09] Guarantees[2]

While *guarantees* are referred to colloquially as security, a guarantor agrees to be responsible to pay a debt owed by another person (*Rowlatt on the Law of Principal and*

[2] This section contains extracts from materials prepared by James A. Titerle for CLE in 1984 and 1985, and by James F. Dixon and Rodney Massel, with the assistance of Daniel LeDressay, in 1984. This section has been updated by editors of the chapter.

Surety, 4th ed., p. 1). The terms "guarantor" and "surety" are essentially the same and accordingly, a contract of surety is the same as a guarantee.

1. Why Get a Guarantee?

A guarantee may be used whenever a party other than the borrower is willing to be at risk for all or part of the borrower's obligations. A guarantee is commonly taken from the principal shareholders of a corporation to support a debt obligation of the corporation. (This is one way for lenders to get around the limited liability of the shareholders of the corporation.) A guarantee is also often required from the parent of a subsidiary corporation to support a loan to that subsidiary.

While guarantees are not security, in certain situations a guarantor will grant security to the lender to secure payment or performance of the guarantee. Therefore, if the principal debtor defaults and the lender looks to the guarantor for payment of the debt, the lender will be secured and will be in a position to realize on its security. It is also common for an individual guarantor to grant a mortgage on their real property to secure a guarantee.

2. Guarantee or Indemnity

A guarantee is connected to another agreement, which is what distinguishes a guarantee from an indemnity (*Morin v. Hammond Lumber Co.*, [1923] S.C.R. 140). An indemnity is an agreement to ensure the lender does not suffer a loss if the debtor does not pay. An indemnity is an independent obligation and does not depend on the relationship between the principal debtor and the creditor:

> …a contract of guarantee is a collateral contract to answer for the default of another person, and thus is a contract that is ancillary or subsidiary to another contract, whereas an indemnity is a contract by which the promisor undertakes an original and independent obligation (20 Hals., 4th ed., 54).

If conflict arises and a court is called upon to decide whether a contract is an indemnity or a guarantee, the courts will attempt to discern the intent of the parties as evidenced by the document itself. In other words, it does not matter what the contract is called: what matters is whether it is in substance a guarantee or an indemnity.

3. Co-Guarantors (Joint and Several Liability)

Often, a lender will obtain guarantees from more than one guarantor. Provided the guarantee is joint and several (generally, guarantees granted by more than one guarantor provide that the obligation of the guarantors is joint and several), the lender may recover the full amount outstanding from any of the guarantors upon a default by the debtor.

A joint or joint-and-several guarantor is entitled to an equitable right of contribution from other joint guarantors (s. 53(3) of the *Law and Equity Act*). Without express agreement or necessary inference to the contrary, when each co-guarantor is equally liable with respect to the same obligation, each of them is liable to the other co-guarantors collectively for the sum of the total obligation divided by the number of co-guarantors. For further reading on contribution, see *BC Creditors' Remedies—An Annotated Guide* (Vancouver: CLEBC).

4. Preparing a Guarantee

It is important to consider the following when a transaction involves a guarantee:

(a) *Business Corporations Act*

Under the *Company Act*—the predecessor to the *Business Corporations Act*, S.B.C. 2002, c. 57—a company could not give a guarantee if the company was insolvent (s. 102). Under both the *Company Act* and the *Business Corporations Act*, when the directors are considering whether a company should provide a guarantee, they must believe that giving the guarantee is in the best interests of the company (*BCA*, s. 142; *Company Act*, s. 103). Therefore, it is usual to require that a company giving a guarantee provide both a certified copy of a directors' resolution stating that, in the directors' opinion, giving the guarantee is in the best interests of the company, and a certificate from an officer of the company confirming that the guarantor is not insolvent.

A lender should not ignore evidence of insolvency, even if an officer gives a certificate stating that the guarantor is not insolvent.

Section 195 of the *Business Corporations Act* provides that a company can give financial assistance to any person for any purpose. However, when financial assistance is given to someone "related" to the company, the company must disclose this to its shareholders, in certain circumstances.

(b) Opinion Letter

It is usual to obtain an opinion letter from the lawyer who acts for the corporate guarantors, which states that the guarantors have the corporate power and capacity to guarantee the debts of the borrower and grant the guarantee, and that the guarantee has been duly authorized, executed and delivered by each of the guarantors. When the guarantee is from individuals, it is common to obtain either a solicitor's certificate with respect to the identity and capacity of the guarantor or, now less common, an opinion letter from the individual guarantors' lawyers stating that each of the individual guarantors has duly executed and delivered the guarantee.

(c) Certificate of Independent Legal Advice

Often the individual guarantors of a borrower's indebtedness derive a real benefit from the loan to the borrower, as is the case where a principal of a company gives the loan to the company. However, when the individual guarantor is not directly related to the business of the company that is obtaining the loan (e.g. the spouse of the principal of the company) it is important for the lender to obtain a certificate of independent legal advice with respect to the guarantor and the guarantor's giving of the guarantee. The certificate of independent legal advice will provide evidence against any claim that the guarantor was unduly influenced, or was under duress, as well as claims of *non est factum* and fraud.

5. Enforcement of a Guarantee

Upon default by the borrower, the lender may look to the guarantor to repay the debt. The lender need not attempt to collect the debt by suing the borrower or by enforcing other security it holds for the debt before proceeding against the guarantor (unless the parties have contracted otherwise). There is no need to demand payment from the guarantor before starting proceedings against the guarantor, unless the guarantee provides otherwise. Normally, however, the lender will write to the guarantor demanding payment. If payment is not received, the lender will then proceed to sue the guarantor under the guarantee. When the lender has taken security from the guarantor to support the guarantee (for example, a mortgage on the guarantor's home), the lender may proceed to realize on its security without first suing the guarantor.

6. Defences to the Creditor's Claim

The courts tend to relieve guarantors from liability under guarantees more readily than they excuse parties to primary contracts. Accordingly, many of the clauses in guarantees are intended to counter defences the guarantor may make against a claim on the guarantee. There are common defences put forth by guarantors:

(a) Release of the guarantor by variation of the principal contract.

By definition, the contract of guarantor is predicated on the existence of a contract between the creditor and a third party, namely the principal debtor. Variation of the contract with the principal debtor will thus have an effect on the contract of guarantee absent provisions in the contract of guarantee itself, which preserve the guarantor's liability if the principal contract is altered. This includes novation of the principal contract. A guarantor may also be released from obligations when the guarantor can prove that there has been a material alteration of the principal contract. This rule is subject to the contract and is usually precluded by standard-form guarantees.

(b) Alteration of the guarantee instrument itself.

(c) Release of the guarantee by giving time to the principal debtor.

(d) Release of the guarantor by impairment of the security.

(e) "Seize or sue."

A guarantor may be discharged as a result of the "seize or sue" provisions in s. 67 of the *PPSA* (see discussion in §3.08(8)).

(f) Foreclosure.

Section 32 of the *Property Law Act*, R.S.B.C. 1996, c. 377, extinguishes the covenant of the mortgagor upon the mortgagee taking an order absolute of foreclosure. If a creditor forecloses upon real property and obtains an order absolute, that creditor will lose the claim against the guarantor.

(g) Questioning the validity of the contract.

A guarantee is a contract. Defences that are normally available for any contract are available to a guarantor. Hence, it is not uncommon for a guarantor to raise defences of misrepresentation, *non est factum*, fraud and mistake.

7. Assignment of Security and Liability

If a guarantor or the co-guarantors pay to the creditor the entire debt, and the debt was secured by security given by the debtor to the creditor, the guarantor or guarantors are subrogated to (they "inherit") the rights of the lender against the debtor and are entitled to a transfer, assignment or conveyance of the security from the creditor. They may then enforce that security against the debtor.

When a guarantor has given the creditor security for the guarantee, and the liability of the guarantor under the guarantee is fully discharged, the guarantor is entitled to a release of the security from the lender.

8. Guarantor's Rights Against a Principal Debtor

Generally, a guarantor is not entitled to relief until the guarantor is obliged to pay. Therefore, the guarantor may not negotiate payment terms with the creditor before the debt is due, nor may the guarantor accelerate its right to seek a remedy against the debtor by paying the debt before it is due.

The guarantor must show that a definite sum is payable. It is insufficient to show that a demand has been made on the guarantor and that it may *eventually* be found that a debt is due.

The guarantor has an immediate right of action against the principal debtor for each periodic payment the guarantor pays under the guarantee in relief of the principal debtor, unless the terms of the guarantee otherwise provide.

A guarantor against whom an action is brought may sometimes obtain indemnification by issuing a third party notice against the principal debtor. When the guarantor uses this remedy in order to enforce an express contract by the principal debtor to indemnify, the guarantor can obtain judgment against the principal debtor before anything has been paid under the guarantee.

The guarantor has a right to full indemnification. It is a right to recover the amount the guarantor has actually paid on behalf of the principal debtor. If there are several guarantors, each may maintain an action against the principal debtor for the amount that each has paid on account of the principal debtor's default.

[§3.10] Due Diligence

When engaging in a commercial transaction that involves a lender taking security, it is important for the lender to conduct a certain level of due diligence to ensure that there are no competing interests of material concern that may compromise the security to be taken by the lender, its value, or its intended priority. The range of due diligence will vary depending on the size of the transaction and the comfort the lender has with the debtor and its assets.

1. Corporate Power and Capacity

A company entering into a transaction to borrow money, grant security, or guarantee the indebtedness of another must have the corporate power and capacity to do so.

Section 30 of the *Business Corporations Act* provides that a British Columbia company has all of the powers and privileges of an individual of full capacity. Section 33 of the *Business Corporations Act* provides that a company shall not carry on a business or exercise a power that it is restricted from doing under its memorandum or articles. Accordingly, before accepting security from a company debtor, the lawyer acting for the secured party must review the memorandum and articles of the company to ensure that it is not restricted from borrowing money, granting security, or guaranteeing the indebtedness of another. Note that there are additional considerations for companies that were incorporated before 1973, mining companies, and companies incorporated for a specific purpose.

It is prudent to obtain certified copies of directors' resolutions that authorize borrowing, granting of security, or guaranteeing debt.

2. *Indian Act*—Section 89

When the security being granted is from a Band or a Status Indian, it is important to consider the effect of s. 89 of the *Indian Act*, R.S.C. 1985, c. I-5. Section 89 restricts the ability of any person who is not an Indian under the *Indian Act* to take and enforce security from a Band or member if the collateral is located on a reserve.

3. Searches

Searches in connection with encumbrances registered against a debtor's property and possible claims against the company are recommended. For a list of searches commonly made, see Chapter 2, §2.06, and the "Asset Purchase Procedure" and "Share Purchase Procedure" checklists in the *Practice Checklists Manual* on the Law Society of BC website (www.lawsociety.bc.ca).

There are many searches that may be performed to disclose other claims that may have priority over *PPSA* security. It is also important to consider whether there are statutes other than the *PPSA* that govern the type of security being taken. Another statute may set out different requirements for the creation of security interests, or grant a lien or other interest in the property of the debtor, which would have priority over the *PPSA* security interest.

Some relevant legislation (e.g. *Bank Act*, *Canada Shipping Act, 2001*, *International Interests in Mobile Equipment (Aircraft Equipment) Act*, etc.) was discussed earlier in §3.03(4).

However, many claims that may have priority due to another statute are not required to be registered and cannot be searched. It is important to explain to a lender that there are occasions where it will not have first priority to the assets of the debtor.

Because of the potential impact of such legislation, lawyers in British Columbia do not give opinions with respect to the priority of security interests in personal property. (This is different from real property, where an opinion as to priority can be provided on the basis of searching the Land Title register.)

[§3.11] Common Pitfalls

The general rules of the *PPSA*, and the policies on which they are based, account for the vast majority of situations involving security. However, there are some tricky situations that arise fairly often. These are things to remember and to watch out for:

- Before filing a financing statement against a debtor's name (or conducting a PPR search of a debtor's name as part of your due diligence), always do corporate searches to determine the debtor's correct legal name.
- A description of equipment without further reference to the "kind" of collateral is inadequate in a security agreement and a financing statement.
- When the secured party wishes to take a security interest in all of the debtor's present and after-acquired personal property located at a specific location, a description of the collateral charged in the security agreement and financing statement as "all of the debtor's present and after-acquired personal property located at, situate on, or used in connection with the following lands…" is not acceptable. Instead, the collateral should be described by "kind" as follows: "all of the debtor's present and after-acquired goods, investment property, instruments, documents of title, chattel paper, intangibles, money, crops or licenses located at, situate on, or used in connection with the following lands…"
- If a secured party wishes to obtain a PMSI on inventory, registration of a financing statement and a PMSI notice to prior secured creditors must be completed before the debtor takes possession of the collateral. PMSI notices are required for inventory but not for other collateral.
- Beware of "seize or sue" if there are any consumer goods included in the collateral covered by the security interest.
- Include "all present and after-acquired" language in collateral descriptions.
- Do *not* include reference to the security agreement, loan agreement, or any other agreement in the collateral description of a financing statement. You must describe the collateral in accordance with s. 10 of the *PPSA*.
- Consider jurisdiction issues if the collateral is mobile goods, intangibles (s. 7) or investment property (s. 7.1). A secured party must protect its interests pursuant to the law of the correct jurisdiction.
- Consider the interplay between the *PPSA* and the *STA* when dealing with collateral that is investment property.
- Remember, title is not relevant under the *PPSA*. Never advise clients that they have priority to goods supplied on conditional sales contracts, even if they have reserved title until the sale price is paid: to have priority, they must comply with the *PPSA*.
- If you are asked to give a priority opinion for a security interest in personal property, *refuse*. There are too many liens and other charges that can exist against personal property and that are not governed by the *PPSA* (for example, interests excluded by s. 4) for you to be able to tell that a client has priority simply by conducting a PPR search. There may also be secured creditors registered after your client who still have priority (for example, PMSI holders).
- Many people mistakenly believe that a promissory note is security. A promissory note is simply a negotiable instrument that creates an obligation to pay. A creditor who has only a promissory note signed by the debtor is unsecured.
- Always register a financing statement for a secured creditor as soon as possible, even if the security interest has not yet attached or even been granted. Remember, once the security interest *does* attach, priority will be determined by the date the financing statement was filed, so to reduce the risk of your client losing priority to another secured creditor, the earlier you file, the better.
- If you are acting for a lessor who is entering into "true" leases (that is, not financing leases) with lessees, remember that if the lease is a "lease for a term of more than one year" it is subject to the *PPSA* (s. 3), and the lessor *could* lose its whole interest in the leased goods, even though it never intended to enter into a security agreement at all. On the issue of whether a lease is a "true" lease or merely a security lease, see *Re Smith Brothers Contracting Ltd.* (1998), 53 B.C.L.R. (3d) 264 (S.C.) and *Re 843504 Alberta Ltd.*, 2011 ABQB 448.

Chapter 4

Introduction to Financial Accounting and Financial Statements[1]

[§4.01] Interpreting Financial Statements

Accounting concepts and financial statements are common in the business world. Since the work of many lawyers relates in some way or another to the business world, you will likely encounter issues related to such concepts in your legal practice, especially if you work in corporate/commercial, general litigation, family or securities. This chapter is intended to provide you with a basic understanding of these concepts. Of course, this chapter is not intended to prepare you to be an accountant or to resolve all accounting-related legal disputes; where financial or accounting matters are involved, it is generally wise to have professional accountants on your client's "team."

This chapter discusses three topics:

(1) components of financial statements (§4.02 and §4.03);

(2) communications made by accountants and auditors (§4.04); and

(3) analytical techniques used to interpret financial statements (§4.05).

The first topic introduces financial statements—these are reports of the financial activities of a business (the terms "business," "entity," "enterprise," "firm" and "company" are used interchangeably in this chapter) presented in a codified and fairly standard format. Users of financial statements must understand the principles and assumptions that underlie them in order to appreciate the limitations and implications of the data contained in them.

The second topic describes the types of communications that accountants or auditors may include with financial statements. Each type of communication conveys a different degree of confidence in the fairness or truthfulness of the financial statements. The type of communication included with the financial statements is often driven by contractual or statutory requirements.

The third topic introduces the general analytical techniques used to interpret financial statements. The usefulness of financial statements to a particular user depends on the user's ability to draw informed conclusions from the data.

When considering these topics in practice, lawyers should be alert to which accounting standards apply in a particular situation. In Canada, since 2011, all public companies must follow the International Financial Reporting Standards ("IFRS") in preparing financial statements. However, most private companies use accounting standards for private enterprises ("ASPE"), so these are the standards you are more likely to encounter in your legal work.

It is not always clear what set of accounting standards will apply to the various aspects of a commercial matter. Accordingly, from the lawyer's perspective, the key is to consider what set of accounting standards could apply in a given situation, and ensure that those matters are discussed with the client and their accountants so that the file is conducted appropriately.

[§4.02] Financial Statements—Generally Accepted Accounting Principles and Assumptions

1. Generally Accepted Accounting Principles

"Generally accepted accounting principles" or "GAAP" include assumptions, rules and guidelines used to prepare financial statements. The following concepts form the foundation of GAAP and will be discussed in greater detail below:

(a) Generally accepted assumptions:

- going-concern assumption
- stable unit of measure assumption
- periodicity assumption

(b) Generally accepted principles:

- (historical) cost principle
- revenue principle
- matching principle
- objectivity principle
- consistency principle
- conservatism principle

Understanding these essential concepts (especially the matching, consistency and historical cost principles) will help you better understand the limitations of financial statements and accounting generally.

[1] **Amir Ghahreman**, C.P.A., C.A., LL.B., Richards Buell Sutton LLP, revised this chapter in February 2024, February 2023, August 2020, July 2019, December 2016, July 2012, and January 2011. Previously revised by Stephen P. Wurz, C.A. IFA (2004); Stephen P. Wurz and Derek M. Sanders (2001); Jeff P. Matthews, C.A. (1995–2000); and Peter G.H. Weldon, C.A. (1993 and 1994). This chapter was originally prepared for PLTC by Johan de Rooy of the UBC Faculty of Commerce in October 1988; updated by the author to April 1991.

2. The Going-Concern Assumption

The "going-concern" or "continuity" assumption refers to the assumption that an accounting entity will continue to operate for a period of time sufficient to carry out its existing commitments.

This assumption allows preparers of financial statements to report assets and liabilities at historical cost (or sometimes at "fair value") in the balance sheet, instead of reporting the current liquidation value of those assets and liabilities.

The going concern assumption is justified in most normal situations. However, it should be dropped when it does not match the facts or when a contract specifies that a different assumption should be used. For example, in reporting statements for a company going into liquidation, the accountant drops the going-concern assumption in order to report, for assets, their liquidation value, and for liabilities, the amount required to settle the debts immediately.

3. The Stable Unit of Measure Assumption

The "stable unit of measure" assumption assumes that money, the basic measuring unit for financial reporting, is a stable unit of value. In other words, accounting mostly ignores inflation or the variable value of currency over time, unless some adjustment is expressly applied.

Accountants might, for example, combine a \$20,000 cost of equipment purchased in 1999 and a \$50,000 cost of similar equipment purchased in 2019 and report the total as a \$70,000 investment.

However, the dollar is not always stable and the prices of goods and services change over time, so assuming a stable unit of measurement, particularly for historical figures, might have limited usefulness.

4. The Periodicity Assumption

Financial statements depend on some things continuing indefinitely (such as major capital assets or subsidiary businesses). However, the users of financial statements need periodic financial measurements in order to make decisions. The "periodicity assumption" allows accountants to divide the life of an entity into time segments, such as a year, and take measurements at these intervals.

The need for frequent measurements creates challenges for accountants. For example, accountants must estimate the useful lives of depreciable assets and apply depreciation methods to those segments of its life. Therefore, periodic measurements of net income and financial position are only informed estimates at best. Users of financial statements should understand these limits when relying on periodic accounting information.

5. The (Historical) Cost Principle

Both the balance sheet and the income statement are affected by the (historical) cost principle. Applying this principle, accountants record assets in the company's accounts at cost and do not adjust this value later, except to allocate a portion of the original cost to expenses as the assets expire through "depreciation," or, if applicable, to write-down the value of certain short-term assets.

At the time an asset is originally acquired, cost usually represents the fair market value of the goods or services exchanged. Over time, however, the fair market value may differ from the historical cost. For instance, the fair market value of land often increases over time from its original historical cost. Applying the (historical) cost principle, these later changes in fair market value are generally ignored in the accounts, and the assets continue to be valued in the balance sheet at historical cost (minus depreciation).

The (historical) cost principle is related to the principle of objectivity, discussed later in this material. Objective evidence readily exists to support cost, whereas evidence supporting market values is more subjective and less readily available.

With the shift to applying IFRS, there are more exceptions to the cost principle for certain assets. Under IFRS, "fair value" measurement occurs frequently (with "fair value" defined in IFRS as "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date").

6. The Revenue Principle

The revenue of a business is the value or consideration received when the business provides goods or services to a third party. Revenue is measured by the cash value of the goods or services exchanged. The revenue principle holds that revenue should be recognized by a business when it is *earned*, not necessarily when cash is *received*; the former refers to "accrual accounting" (required by GAAP) and the latter to "cash accounting."

7. The Matching Principle

The matching principle holds that expenses directly associated with earning revenues should be recorded in the same period in which the revenue is reported, so that expenses are "matched" with the revenue they generate. In other words, when revenue has been earned, the expenses incurred to generate that revenue should be offset (matched) against that revenue to derive the net *income* from the transactions. Expenses are matched as of when they are *incurred*, not when they are *paid*.

Together, the matching and revenue principles produce the *accrual accounting* model which is the model that should be used by all businesses for preparing external financial statements. The accrual model calculates income as revenue *earned* (not necessarily collected) minus expenses *incurred* (not necessarily paid) to generate that revenue. Accordingly, net income will not mirror a business's actual change in cash position.

8. The Objectivity Principle

The objectivity principle holds that financial measurements should be based on evidence that is objective—that is, unbiased and subject to verification by independent experts. For example, price in an arm's length transaction is an objective measure of market value at the time of the transaction. Invoices, contracts, paid cheques, and inventory counts are other examples of objective evidence.

9. The Consistency Principle

The consistency principle states that once a company adopts a particular accounting method, it will not change that method from period to period. This principle allows users of financial statements to compare financial statements from different periods and to interpret changes in financial position.

If a company *does* change accounting methods, it should disclose this in the notes to the financial statements.

Issues related to this principle often arise when a transaction occurs or is anticipated to occur and one party has an incentive to influence the reported financial results.

10. The Conservatism Principle

The conservatism principle speaks to the risk-averse nature of accounting. It means that when there is uncertainty and estimates must be made, accountants will avoid overstating assets, revenues and gains, and avoid understating liabilities, expenses and losses.

[§4.03] Financial Statements

A full set of financial statements includes six parts:

(1) an accountant's or auditor's communication about the financial statements;

(2) a balance sheet (statement of financial position);

(3) a statement of income and retained earnings;

(4) a statement of cash flows;

(5) notes to the financial statements; and

(6) comparative information for the preceding fiscal period (usually displayed within the above five components).

Together, these components attempt to convey a financial picture of the business, subject to the limitations of financial reporting. If any of these items is absent, the users of the financial statements will usually require an explanation (although many private companies will greatly simplify the "notes" if they are not required to produce them for any specific external requirement, such as bank compliance).

From the lawyer's perspective, the balance sheet and statement of income are the most relevant items.

The sections that follow use Acme Limited's financial statements to review the basic components of financial statements (except accountants' and auditors' communications, which are discussed in §4.04). Refer to the Acme Limited financial statements (Appendix 4) to ensure you understand the concepts discussed.

1. The Balance Sheet

The balance sheet reports the financial position of an entity at a particular point in time. Just like a camera freezes an image in time, a balance sheet records a company's assets, liabilities and equity accounts as they are on the date for which the balance sheet was prepared. (For Acme, that point in time is December 31, in each of 2023 and 2022).

The balance sheet organizes the accounts under three broad categories: assets, liabilities, and equity.

Assets are items that the business owns or controls. Assets are used to earn income or revenue in subsequent fiscal periods, and include the following:

- cash or cash equivalents;
- future cash inflows (e.g. accounts receivable);
- future benefits (e.g. inventories, property, plant and equipment); and
- unexpired costs (e.g. goodwill and prepaid expenses).

Liabilities and equity represent different methods for financing or paying for the assets.

- **Liabilities** represent monies or credit extended to the entity by non-owners to allow the entity to acquire assets.
- **Equity** represents the funds provided by owners (e.g. to purchase shares from the company) or by the business (e.g. retained earnings), and is also the residual interest shareholders have in the enterprise as measured in historical cost values.

Anything that an entity owns (assets) must have been paid for or financed from some source of funds such as creditors' money (liabilities), the owners' money (capital stock) or the entity itself (retained earnings). Consequently, a fundamental relationship between these balance sheet accounts is expressed by the following equation:

Assets = Liabilities + Equity

A review of Acme's balance sheet reveals that on December 31, 2022 and 2023, this equation was as follows:

December 31, 2022

$3,452,830 = $1,759,899 + $1,692,931

December 31, 2023

$3,964,360 = $1,809,176 + $2,155,184

The balance sheet also distinguishes between accounts that are "current" and those that are "non-current." The purpose of this classification is to distinguish figures and accounts that are part of the short-term operation of the business ("current accounts") from accounts that are not ("non-current" or "long-term" accounts).

The current accounts indicate the liquidity of the business. Current assets represent cash or cash inflows to be realized within the upcoming year (e.g. accounts receivable). Current liabilities represent cash to be paid out in the upcoming year (e.g. accounts payable). If current assets exceed current liabilities, it suggests that the entity is liquid and will be able to pay off liabilities as they come due. The reverse relationship indicates that cash outflows might exceed cash inflows, causing potential financial difficulties for the business in the foreseeable future.

Non-current assets represent the productive assets of a business (e.g. the property, plant and equipment used in the business's operations). Non-current liabilities represent the long-term financing costs to acquire these assets, including cash outflows expected to be made one or more years later.

Equity, i.e. the residual interest of the owners in the business, is a non-current item because the primary way to convert equity into a cash outflow is to liquidate the business, which would be contrary to the going-concern assumption.

2. The Statement of Income and Retained Earnings

The statement of income and retained earnings contains two subsets:

- a statement of income (or "income statement"); and
- a statement of retained earnings.

These statements are frequently presented as two separate statements. Each component warrants special consideration.

The income statement reports the results of a business operation over a particular time period, usually one year. If a balance sheet is like a photograph, an income statement is like a movie which shows what takes place over a period of time. The statement provides the details of the revenues (the inflow of assets or reduction in liabilities) and expenses (the outflow of assets or increase in liabilities) incurred to earn those revenues. The difference between the revenues and expenses is **net income** (or net loss) for that period.

The income statement typically divides revenues and expenses into categories that portray the major activities of the business. A reader can therefore see how different parts or sectors of the business are performing.

The statement of retained earnings presents the changes in the retained earnings during the time period. "Retained earnings" refers to the income that the enterprise has generated since inception, less the amount distributed to owners as dividends. Where this amount is negative, it is sometimes referred to as an "accumulated deficit" or just a "deficit." The statement of retained earnings identifies the retained earnings at the beginning of the year ("opening retained earnings"), adds the net income earned and subtracts the amounts distributed to owners as dividends to determine the balance at the end of the year ("closing retained earnings"):

Opening Retained Earnings for the year	+	Net Income	−	Dividends	=	Closing Retained Earnings for the year

In the case of Acme, this relationship for 2022 and 2023 is:

<u>2022</u>:
$1,170,523 + $220,908 – $8,500 = $1,382,931

<u>2023</u>:
$1,382,931 + $373,253 – $11,000 = $1,745,184

3. The Statement of Cash Flows

The statement of cash flows is the most complex of the statements prepared by accountants. It builds on the information in the other statements and consolidates the data into a single report from a cash flow perspective. It also usually requires knowledge of the entity's transactions beyond what is reflected on the surface of the financial statements.

For larger companies and for public companies the statement of cash flows is very important, whereas many private or non-regulated businesses do not even prepare a statement of cash flows.

A statement of cash flows classifies cash receipts and payments into three major categories:

(1) operating activities;

(2) investing activities; and

(3) financing activities.

Grouping cash flows into these categories identifies the effects on cash of each of the major activities of a company.

(a) Operating Activities

A statement of cash flows shows the transactions that constitute the company's operating activities. Generally, the cash effects of these transactions determine the net cash flow resulting from operating activities.

The primary operating cash inflows are cash receipts from customers resulting from sales made or services rendered.

Typical operating cash outflows include cash payments for merchandise purchases or settling other accounts payable, cash payments to employees, cash payments to outside suppliers for various services and supplies, and cash payments for taxes.

(b) Investing Activities

A company's investing activities consist of transactions involving the acquisition and disposal of plant assets and intangible assets, and the lending and subsequent collection of money. The related cash receipts and payments appear in the "investing activities" section of the statement of cash flows. Cash inflows come from events such as cash sales of plant assets and intangible assets, cash sales of investments in shares and bonds, and loan repayments from borrowers. Typical cash outflows related to investing activities include cash payments made in order to purchase shares and bonds, and cash loaned to borrowers.

(c) Financing Activities

A company engages in "financing activities" when it takes money from owners, borrows money from creditors, and repays amounts borrowed. Cash flows related to these events are reported in the "financing activities" section of the statement of cash flows. For example, this section would report cash received for issuing shares or bonds, and cash paid out in dividends or to reduce long-term debts. Among other things, reports on financing activities show a user of the financial statements whether the business relies heavily on issuing shares or bonds to finance its operations.

4. Notes to Financial Statements

The notes to financial statements complete the reporting process, providing qualitative information to explain and support the quantitative information in the financial statements. The notes also provide more detailed quantitative data that cannot be presented on the other components of the financial statements.

The information in the notes to the financial statements should:

(a) summarize key accounting policies applied by the entity, to explain how the financial statements' balances were derived (see Note 1 to Acme's financial statements);

(b) break down consolidated amounts (see Notes 3 and 4);

(c) describe events and conditions critical to deriving these amounts (see Notes 5 and 6); and

(d) describe contingencies and events subsequent to the balance sheet data that have a significant continued effect on the entity (see Notes 7, 8 and 9).

Most financial statements will explicitly refer to these notes. For example, Acme's balance sheet, income statement, and statement of cash flows explicitly state, "The accompanying notes are an integral part of these financial statements." Many of the accounts on the balance sheet also refer to the notes. Readers should review the notes closely and consider how they affect the information reported in the other financial statements.

5. Comparative Information

Under GAAP, external financial statements should provide comparative financial information (i.e. dollar figures) for the preceding fiscal period. Comparative balances allow readers to evaluate the business's current performance and financial position relative to another period in time. In particular, comparative information allows users of the financial statements to:

(a) Identify changes in relative and absolute amounts.

These differences allow users to consider whether the changes say anything about how well the business is being managed.

(b) Predict future performance.

Financial statements generally calculate past results. Past results are a useful starting point for future projections.

(c) Isolate relationships between figures and consider their implications.

For example, the figures for Acme indicate that something is amiss with their inventory. Acme's sales increased by about 8% from 2022 to 2023. Accounts receivable represents the portion of sales that are uncollected as at the balance sheet date, so a reader would expect to see an equivalent increase there. The actual increase on Acme's balance sheet is about 4%, which shows a reasonable harmony between sales and accounts receivable. Inventory, the items ready to be sold, should presumably also increase similarly with sales. However, Acme's inventories increased by 34% during the year! Something appears amiss and further investigation is warranted. If this rate of increase continues, Acme will soon face a liquidity problem if it continues to invest in inventory (a non-cash asset).

[§4.04] Accountants' and Auditors' Communications[2]

External financial statements produced by a professional accountant are covered by a "report" that tells the reader the nature of the accountant's involvement with the financial statements.

Three types of reports are used by accountants issuing financial statements to the public:

(a) an Auditor's Report;

(b) a Review Engagement Report; and

(c) a Notice to Reader (or "Compilation Report").

(See the end of this section for examples of these reports.)

Each report explains the degree of assurance or credibility that the accountant is adding to the financial statements.

The highest level of assurance is provided by an "Auditor's Report," in which the accountant states an opinion on the fairness or truthfulness of the information presented in the financial statements. The Auditor's Report gives readers reasonable assurance that the statements are free from material misstatement.

In a "Review Engagement Report," the accountant does *not* render an audit opinion on the financial statements, but provides only negative assurance that "nothing has come to our attention" to suggest the statements are materially incorrect. This type of report may be prepared when shareholders have waived their right to an audit.

Finally, a "Notice to Reader" or "Compilation Report" cautions that the accountant has only received information from the client and arranged it into financial statements. The accountant has taken no steps to verify or review the information, and provides *no* assurance about it.

Lawyers must understand how these types of reports differ, so that they can advise clients accordingly.

The following paragraphs describe these communications in more detail.

(a) Audits

Most limited companies are required by law to present annual financial statements to their shareholders. Unless the shareholders waive this right, these statements must be audited by an independent Chartered Professional Accountant. The auditor is responsible to the shareholders and reports to them. In addition, an audit may be required under a lending agreement or a major contract.

The objective of an audit is to obtain *reasonable assurance* that the financial statements as a whole are not materially misstated. Auditors *do not* guarantee the accuracy of financial statements; rather, they render their professional opinion as to the overall fairness of the statements. "Fairness" means that the financial statements are not misleading.

There is always a possibility that an auditor's opinion is in error, or that the auditor was intentionally misled by management. Although the auditor exercises due care and diligence in auditing the information, the Auditor's Report clearly indicates that management is ultimately responsible for the accuracy of the information.

The audit usually involves inspecting financial records and operations, confirming with external third parties the accuracy of balances due to or from the company, examining supporting documents to assure authenticity, and evaluating the company's internal control procedures to ensure systems are in place to safeguard the company's assets and accounting records. However, it is not practicable to verify all information, nor would it be affordable for most organizations to pay auditors to do so. Therefore, many of the auditor's procedures are done on a sample testing basis. Partly due to this, an audit does not provide 100% assurance.

[2] Part of the material in this section was kindly provided by the Institute of Chartered Professional Accountants of British Columbia and adapted for PLTC.

If the auditor disagrees with the company about the accuracy or fairness of the financial information presented, the auditor will qualify the report with specific reference to the disagreement. On those rare occasions, the auditor must state the nature of the disagreement and the impact of the disagreement on the financial statements. Such disagreements might involve the valuation of assets or the method of recording revenue.

In the coming years, audit evidence requirements may need to evolve to keep pace with technological changes, in particular arising from artificial intelligence. Traditional steps used to obtain reasonable audit evidence are currently being revisited as part of a long-term project by the Canadian Auditing and Assurance Standards Board.

(b) Review Engagements

The objective of a review is to discover if the financial statements are *plausible*, applying GAAP. As noted earlier, the Review Engagement Report provides only negative assurance that nothing has come to the accountant's attention to suggest the statements are materially incorrect.

The review involves inquiry, analytical procedures, and discussion about information supplied by the company. The accountant must exercise due care in reviewing the financial statements. If anything comes to light that suggests the statements do not adhere to GAAP or are misleading, the accountant must disclose this fact in the Review Engagement Report. Accountants cannot be associated with financial statements which they know or believe are misleading or incorrect, and they must disassociate themselves from the statements if the company is averse to changing them.

A review may be adequate for the needs of financial statement users where there is limited risk exposure, or where the shareholders are involved in the day-to-day operations of the business.

(c) Compilation Reports (formerly also known as "Notice to Reader")

Until quite recently these were known as "Notice to Reader" engagements and their reports were titled as such, so it is likely that you will still encounter them with this historical name in the coming years.

Accountants are often asked to compile financial statements when there is no need for the assurance provided by an Auditor's Report or a Review Engagement Report. For instance, management may want financial statements for internal management purposes or for income tax purposes, and there may be no bank covenant requiring more formal reports.

In this case, the accountant receives information from the client and arranges it into a financial statement. The accountant is *not* required to verify, corroborate or review information supplied by the client. The accountant's concern is simply that the information is correctly assembled. The accountant gives *no assurance* that there is no reason to believe that the financial statements are false or misleading.

The Compilation Report is intended as a clear warning of the limited usefulness of these statements. For decision-making purposes, readers of statements prefaced by a Compilation Report who do not have access to other information should consider seeking the assurance provided by an audit or review.

A key part of the Compilation Report is that it must reference a note in the accompanying "notes" that describes the basis of accounting applied in preparing the financial statements. Usually the basis of accounting will deviate from GAAP (whether APSE or IFRS) and this note will provide information relevant to understanding those differences. This note will usually describe a basis of accounting which is not compliant with GAAP, such as the cash basis of accounting, the cash basis of accounting with certain selected aspects of accrual accounting, or accrual accounting with certain selected aspects of cash accounting.

Examples of these reports (i.e. audit, review and compilation) follow below.

INDEPENDENT AUDITOR'S REPORT

[Addressee]

Opinion

We have audited the financial statements of ABC Company (the "Company"), which comprise the balance sheet as at December 31, 20XX, and the statements of income, retained earnings and cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies.

In our opinion, the accompanying financial statements present fairly, in all material respects, the financial position of ABC Company as at December 31, 20XX, and the results of its operations and its cash flows for the year then ended in accordance with the applicable financial reporting framework.

Basis for Opinion

We conducted our audit in accordance with Canadian generally accepted auditing standards. Our responsibilities under those standards are further described in the Auditor's Responsibilities for the Audit of the Financial Statements section of our report. We are independent of the Company, in accordance with the ethical requirements that are relevant to our audit of the financial statements in Canada, and we have fulfilled our other ethical responsibilities in accordance with these requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Material Uncertainty Related to Going Concern

[where there is a material uncertainty about the entity's ability to continue as a going concern]

We draw attention to Note X in the financial statements, which indicates that the Company incurred a net loss of $X during the year ended December 31, 20XX and, as at that date, the Company's current liabilities exceeded its total assets by $X. As stated in Note X, these events or conditions, along with other matters as set forth in Note X, indicate that a material uncertainty exists that may cast significant doubt on the Company's ability to continue as a going concern. Our opinion is not modified in respect of this matter.

Other Information

[where applicable, such as for annual reports]

Management is responsible for the other information. The other information comprises the information included in [X report], but does not include the financial statements and our auditor's report thereon. Our opinion on the financial statements does not cover the other information and we do not express any form of assurance or conclusion thereon.

In connection with our audit of the financial statements, our responsibility is to read the other information and, in doing so, consider whether the other information is materially inconsistent with the financial statements or our knowledge obtained in the audit or otherwise appears to be materially misstated. If, based on the work we have performed, we conclude that there is a material misstatement of this other information, we are required to report that fact. We have nothing to report in this regard.

Responsibilities of Management and Those Charged with Governance for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with the applicable financial reporting framework, and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

In preparing these financial statements, management is responsible for assessing the Company's ability to continue as a going concern, disclosing, as applicable, matters related to a going concern and using the going concern basis of accounting unless management either intends to liquidate the Company or to cease operations, or has no realistic alternative to doing so.

Those charged with governance are responsible for overseeing the Company's financial reporting process.

Auditor's Responsibilities for the Audit of the Financial Statements

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with Canadian generally accepted auditing standards will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements. As part of an audit in accordance with Canadian generally accepted auditing standards, we exercise professional judgment and maintain professional skepticism throughout the audit.

We also:

- Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.
- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control.
- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by management.
- Conclude on the appropriateness of management's use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty ex-

ists related to events or conditions that may cast significant doubt on the Company's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our auditor's report to the related disclosures in the financial statements or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our auditor's report. However, future events or conditions may cause the Company to cease to continue as a going concern.

- Evaluate the overall presentation, structure and content of the financial statements, including the disclosures, and whether the financial statements represent the underlying transactions and events in a manner that achieves fair presentation.

We communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that we identify during our audit.

[Auditor's signature]
[Date of the auditor's report]
[Auditor's address]

INDEPENDENT PRACTITIONER'S REVIEW ENGAGEMENT REPORT

[Addressee]

We have reviewed the accompanying financial statements of ABC Company that comprise the balance sheet as at December 31, 20XX, and the statements of income, retained earnings and cash flows for the year then ended, and a summary of significant accounting policies and other explanatory information.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with [Canadian accounting standards for private enterprises], and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

Practitioner's Responsibility

Our responsibility is to express a conclusion on the accompanying financial statements based on our review. We conducted our review in accordance with Canadian generally accepted standards for review engagements, which require us to comply with relevant ethical requirements.

A review of financial statements in accordance with Canadian generally accepted standards for review engagements is a limited assurance engagement. The practitioner performs procedures—primarily consisting of making inquiries of management and others within the entity, as appropriate, and applying analytical procedures—and evaluates the evidence obtained.

The procedures performed in a review are substantially less in extent than, and vary in nature from, those performed in an audit conducted in accordance with Canadian generally accepted auditing standards. Accordingly, we do not express an audit opinion on these financial statements.

Conclusion

Based on our review, nothing has come to our attention that causes us to believe that the financial statements do not present fairly, in all material respects, the financial position of ABC Company as at December 31, 20XX, and the results of its operations and its cash flows for the year then ended in accordance with [Canadian accounting standards for private enterprises].

[Practitioner's signature]
[Date of the practitioner's report]
[Practitioner's address]

COMPILATION REPORT

To Management of ABC Company

On the basis of information provided by management, we have compiled the balance sheet of ABC Company as at December 31, 20XX, the statement of income and retained earnings for the year then ended, and Note X, which describes the basis of accounting applied in the preparation of the financial information [and other explanatory information].

Management is responsible for the accompanying financial information, including the accuracy and completeness of the underlying information used to compile it.

We performed this engagement in accordance with Canadian Standard on Related Services (CSRS) 4200, Compilation Engagements, which requires us to comply with relevant ethical requirements. Our responsibility is to assist management in the preparation and presentation of the financial information of the entity.

We did not perform an audit engagement or a review engagement, nor were we required to perform procedures to verify the accuracy or completeness of the information provided by management. Accordingly, we do not express an audit opinion or a review conclusion, or provide any form of assurance on the financial information.

Readers are cautioned that the financial information may not be appropriate for their purposes.

[Practitioner's signature]
[Date of the practitioner's report]
[Practitioner's address]

[§4.05] Financial Statement Analysis

Financial statement analysis is the process of analyzing an entity's financial statements to determine the entity's financial position and to make decisions. Various techniques are used in the analysis of financial data. This material addresses only two of the most common techniques: comparative (trend) analysis and ratio analysis.

1. Comparative Analysis

Comparative analysis involves looking for trends, by comparing information about the entity from period to period.

Most financial statements include information for the preceding year. Users of financial statements can begin to form certain conclusions by identifying whether certain numbers have gone up or down, particularly in light of other items that have changed. For instance, have sales increased? If so, then the entity's business has probably expanded somewhat. On the other hand, have sales decreased while expenses have increased? If so, something may be awry.

In Appendix 4, we see in Acme's Balance Sheet that $5,000 of dividends were payable in 2022 but $0 of dividends in 2023; that may be relevant. We also see that inventories have increased significantly on the balance sheet, from $1,174,702 to $1,575,438; the increase seems disproportionate to the change in sales. Why the change? As the lawyer you are not expected to answer such questions, but it will help to be able to identify relevant changes.

2. Ratio Analysis

Ratio analysis involves using numbers from the financial statements to obtain information about a company. This material focuses on three types of financial ratios:

(a) **Liquidity ratios** measure a company's ability to meet its current obligations (cash outflows) as they come due.

(b) **Solvency ratios** measure a company's ability to pay the principal and interest on debt in the long term.

(c) **Profitability ratios** measure a company's ability to generate income.

These types of ratios are among those most frequently used, and lenders often require companies to maintain certain ratio levels to keep their loans in good standing.

3. Liquidity Analysis

"Liquidity" refers to the ability of an entity to meet its obligations to short-term creditors. Liquidity is important because if the entity cannot meet its short-term debt-paying ability, it will not be able to maintain its long-term debt-paying ability, or to satisfy its shareholders. Some liquidity ratios focus on the company's liquidity at a particular point in time, while others (also called "activity ratios") assess how efficiently the company uses its current assets to generate cash.

Analyzing liquidity requires an understanding of "current assets" and "current liabilities": current assets represent cash or cash inflows to be realized within one year, and current liabilities represent cash to be paid out within one year.

The ratios most commonly used to measure liquidity are the **current ratio** and the **quick (or acid test) ratio**.

The **current ratio** shows how many dollars of current assets the company has for each dollar of current liabilities. For example, as shown at Appendix 5, Acme had a current ratio of 1.92-to-1 in 2023. This means that Acme had $1.92 invested in current assets for every dollar in current liabilities.

The closer a company's current ratio is to 1, the more likely the company will have difficulty in meeting its short-term obligations. In general, a current ratio of at least 2-to-1 is desirable. However, whether a particular current ratio is acceptable depends on the trend in the ratio over time and how it compares with ratios for similar companies. Too high a current ratio can also be undesirable—it can indicate that the company has too much money invested in current assets, which are normally non-income-producing, rather than in fixed assets, which are income-producing.

Current assets normally consist of cash, marketable securities, accounts receivable, inventory, and prepaid expenses. Of these items, inventory and prepaid expenses are considered the least liquid assets, because they are the furthest from being converted into cash—inventory must first be sold and the sales collected, and prepaid expenses cannot be readily sold for cash. As a result, analysts often calculate an additional liquidity ratio called the **quick ratio** to provide further insight than the current ratio by removing inventory and prepaid expenses from current assets. From a creditor's perspective, the quick ratio more meaningfully evaluates the company's liquidity and ability to meet payments when due.

Acme's 2023 quick ratio of .68 would normally be considered poor, because it is less than 1 and indicates that the company has insufficient cash and cash equivalents to meet its short-term obligations.

Turnover or **activity ratios** measure how efficiently the company uses its assets. Acquiring and using assets is costly. If the assets do not generate sufficient sales, overall profitability will suffer. Two commonly used activity ratios are accounts receivable turnover and inventory turnover.

Accounts receivable turnover indicates how many times a year a company collects its receivables. The accounts receivable turnover ratio can be used to estimate the average number of days required to collect a receivable, commonly referred to as the "collection period." At Acme, an account receivable remained outstanding for an average of 52 days in 2023. Whether this number is acceptable depends on the company's policy for granting credit.

Inventory turnover measures the number of times a year that the company sells its inventory. Acme turned over its inventory approximately 2.59 times a year, or every 141 days in 2023. Of course, a company could maximize its inventory turnover and minimize inventory costs by keeping inventory low, but this policy could mean missing out on sales opportunities or inability to fulfill orders received and thereby losing customer goodwill. As a result, management wants to maximize inventory turnover while ensuring that enough inventory is available to meet customer needs.

In sum, the formulas for these liquidity ratios are as follows:

Current Ratio	=	Current Assets / Current Liabilities
Quick Ratio (Acid Test)	=	Quick Assets* / Current Liabilities
Accounts Receivable Turnover	=	Sales / Average Accounts Receivable
Accounts Receivable Turnover (In Days)	=	365 / Accounts Receivable Turnover
Inventory Turnover	=	Cost of Goods Sold / Average Inventory
Inventory Turnover (In Days)	=	365 / Inventory Turnover

* Calculated as either:

Cash + Marketable Securities + Accounts Receivable

or

Current Assets – Inventory and Prepaid Expenses

4. Solvency Analysis

Business debt involves two obligations: to repay the principal and to pay interest while the principal is owing. Solvency analysis measures a company's ability to repay the principal and interest on debt in the long term (as compared to liquidity analysis, which focuses on the entity's ability to repay short-term debt). Creditors often want information about the solvency of a company in order to determine whether the company will be able to keep up on its interest payments.

Solvency ratios are sometimes referred to as **leverage ratios**. "Leverage" refers to the amount of debt a company uses to finance its assets. The more debt, the more highly leveraged the company. Leverage has advantages and disadvantages. Its main advantage is that by using someone else's money, owners can maximize their returns. Its main disadvantage is that leverage increases the company's exposure to risk: increased leverage means increased interest payments, and if a company starts to earn less than it pays out, the company can end up defaulting on its debts and going bankrupt.

There are two approaches to assessing solvency:

- The **debt ratio** measures the company's ability to carry debt, as indicated by the balance sheet.
- The **times-interest-earned ratio** measures the company's ability to carry debt, as indicated by the income statement.

The **debt ratio** is calculated by dividing total liabilities by total assets. The resulting number shows the percentage of assets financed by debt. In 2023, Acme financed 46% of its total assets with debt and the rest, 54%, with equity. Acme's 2022 debt ratio (51%) shows that the company's debt ratio has decreased. This is largely due to the fact that the company financed its increase in assets in 2023 through the company's own retained earnings, as opposed to external debt.

The **times-interest-earned ratio** shows the margin by which the company's income (before interest and taxes) exceeds interest payments. It is calculated by dividing the income (before interest and tax) by the interest expense. This figure shows how much income could decline before jeopardizing the payment of interest. In 2023, Acme's income available to meet interest payments was 6.66 times the amount of these payments—a good margin of safety. If the ratio were less than 1, it would indicate that the income before interest was less than the interest expense, resulting in a net loss. Repeated times-interest-earned ratios of less than 1 suggest that the entity's financial demise is inevitable, whereas a repeatedly high ratio suggests that the enterprise is not maximizing its use of debt financing.

In sum, the formulas for the debt ratio and the times-interest-earned ratio are as follows:

$$\text{Debt Ratio} = \frac{\text{Total Liabilities}}{\text{Total Assets}}$$

$$\text{Times Interest Earned} = \frac{\text{Income Before Interest Expense and Tax}}{\text{Interest Expense}}$$

5. Profitability Analysis

Profitability is the ability of the company to generate positive income.

Profitability ratios are probably the most important ratios to financial statement users. Profits are important to shareholders because they derive revenue in the form of dividends, which are paid from profit, and increased profits can also increase the market price of shares, leading to capital gains. Profits are also important to creditors, because they are a source of funds for debt coverage. Management is also interested in profit, as it is often used as a performance measure.

One indication of a company's profitability is its net income. However, net income alone is often misleading in a performance evaluation because net income is an absolute number when, in fact, profits should be evaluated in the context of the company's size and competitive position. As a result, analysts typically construct profitability ratios to compare net income with sales, assets, or shareholders' equity. These ratios are described below.

The **return on sales** (also known as the **profit margin**) measures how much the company earns on every dollar of sales. In 2022, Acme earned approximately \$.048 on every dollar of sales, while in 2023 the amount increased to \$.077. Most retailers, such as grocery store and department store owners, have very small profit margins but high turnover. Without this turnover, profits would be low. In contrast, manufacturers of heavy-duty equipment, such as tractors and computers, have low asset turnover but high profit margins. Thus, each sale generates a significant profit for the company.

The **return on assets** measures how well the company is doing relative to its level of investment in assets. For example, assume Company A and Company B each had net earnings of \$10,000 in YR1. Company A had total assets of \$100,000 while Company B had total assets of \$80,000. What can we conclude from this data? All other things being equal, Company B earned a greater return on its investment than Company A. Company A had a return on assets of 10% (\$10,000/\$100,000), while Company B had a return on assets of 12.5% (\$10,000/\$80,000). Without relating net income to some measure of investment—in this case, total assets—a misleading picture of performance could result.

Despite the usefulness of return on assets, shareholders are often more interested in determining the return on their own investment. From the shareholder's vantage point, a company's **return on equity** is of particular importance. Return on equity measures the company's ability to generate income from its shareholders' investments, and is calculated by dividing net income by total equity.

In 2023, Acme's return on assets was 9.4%; its return on equity was 17.2%. Why is this the case? Take, for instance, a company with no debt or liabilities. In such a case, the company's total assets would equal its total equity, and return on assets and equity would be equal. To the extent that a company uses debt, the return on equity will differ from the return on assets. For example, if a company realizes a return on borrowed capital greater than the amount of interest paid, return on equity will be higher than return on assets, because any excess returns accrue to the shareholders without the shareholders having to increase their investment.

To review, the profitability ratio formulas are as follows:

$$\text{Return on Sales} = \frac{\text{Net Income}}{\text{Sales}}$$

$$\text{Return on Assets} = \frac{\text{Net Income}}{\text{Total Assets}}$$

$$\text{Return on Equity} = \frac{\text{Net Income}}{\text{Total Equity}}$$

[§4.06] Conclusion

This chapter is intended to familiarize you with the key accounting terms and financial statement concepts that are frequently encountered in the practice of law. However, the accounting process and financial statements are much more intricate than this chapter might suggest. Just as accountants generally seek legal counsel when facing situations requiring legal interpretation, when you are dealing with financial information that is not straightforward, or where financial statements may be important to the matter you are working on, you should recommend to your client that they consult with an accountant who is sufficiently experienced in the matters at hand.