CANADIAN
EQUIPMENT FINANCE
NOV/DEC 2014 • VOLUME 2 • ISSUE 6 | WWW.CANADIANEQUIPMENTFINANCE.COM

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DISCONNECTION NOTICE

Some Legal Aspects of Remote Disabling Technologies

By Eric Grossman, CPA CGA

"They're my machines and if you don't pay, I'll shut you down!"

A client recently made this angry exclamation after I mentioned my legal concerns surrounding the fact that he remotely disabled equipment used by his customers on two occasions.

This client manufactures digitally controlled equipment that requires a time-sensitive activation code. If he doesn't renew a machine's activation code, the machine stops and cannot be restarted until he provides a new code. His company regularly communicates with all installed units so that faults or failures can be detected and addressed immediately, consumables can be shipped automatically when they run low, and preventive maintenance schedules can be based on actual hours of use.

Not all equipment is designed to be so easily disabled, but there are a growing number of equipment manufacturers, lenders, owners, and users who install third-party technologies that can be used remotely to disable or to locate, whether through GPS, cellular, or web-based networks.

The client told me about disabling his customers' machines because he was offering to give me that same enforcement tool when I began financing his customers' purchases. After shouting, he mumbled that one customer's lawyer had forced him to restart a machine before the delinquent payment was made. He had no idea what his error might have been.

In fact, he was lucky that the customer didn't sue for financial losses because of his actions because he likely would have been found liable.

In order to avoid problems when remotely disabling equipment, let's review the legal structures around this practice.

Disablement means taking possession

At least in Ontario, at present the 'Personal Property Security Act' (the 'PPSA') 62(b) states that upon default under a security agreement, if a secured party renders equipment unusable without removing it from the debtor's premises, the secured party is deemed to have taken possession of the equipment. So when my client disabled his customers' units, he was considered under the law to have taken possession of or seized the equipment, even though he never attended their premises.

However, for the disablement to be deemed a legal seizure, the PPSA requires that "the security interest has been perfected by registration". If there is no valid registration, this would not be considered a legal seizure. Since my client did not register his interest in the equipment he disabled, his actions left him liable for any damage caused. He could, in fact, be guilty of conversion, the improper taking of property from another without due authority, for which a civil action could be brought.

After taking possession, additional rules come into play to govern how the creditor must act, so it's best to be

cautious when considering any decision to disable equipment.

Notice of taking possession

While it's true that the Personal Property Security Act in most provinces allows a secured creditor to take possession of collateral by any method permitted by law, it is silent about whether any notice of the impending seizure is required to be given. However, Canada's 'Bankruptcy and Insolvency Act' and the common law (court decisions) do set out some notice requirements.

(a) 'Bankruptcy and Insolvency Act' ('BIA')

Under the BIA 244, a secured party who intends to enforce a security must provide at least ten days' notice, if there is intent to take possession of "all or substantially all of (a) the inventory, (b) the accounts receivable, or (c) the other property of an insolvent person that was required for, or is used in relation to, a business carried on by the insolvent person." In other words, if the debtor relies on the equipment to carry on its business and is understood to be insolvent (unable to pay its debts as they come due), ten days' written notice is required. The notice period can be shortened if the debtor consents, but the full notice must still be given first.

Even if the lender's security documents contain an acknowledgement by the debtor that the equipment is not essential to their business, when later there is a default, this acknowledgement won't help the lender if the equipment proves in fact to be essential. For example, if my one of my client's customers had to close its doors because he disabled their equipment, it would be difficult to argue that the equipment was not essential, no matter what the agreements said. My client would therefore have been prudent to send the required notice at least ten days before the old activation code expired, if there were any chance that the equipment could constitute "all or substantially all" of the equipment his customer relied on at that moment.

(b) Common law

The common law, developed over time by judges through their decisions, has required, at least since the 1982 Supreme Court of Canada decision in Lister v. Dunlop, that some reasonable notice of intention to take possession must be provided in writing, in order to allow the debtor some reasonable time in which to act to cure the default. The failure to provide reasonable notice and the subsequent seizure of assets may expose a creditor and its agents to damages for breach of contract, conversion, or trespass.

Deciding what is reasonable notice is not simple. Some of the factors to be considered are the amount of the loan, the risk of loss to the creditor, the age of the relationship with the debtor, the character and reputation of the debtor, the potential ability to raise the money in a short time, and the circumstances surrounding the demand for payment. The larger the loan, the longer is the reasonable notice period, since it would be more difficult and take longer to raise more money. If the risk of loss to the creditor is high, such as in the case of high-value units left unattended in a public place, then a shorter notice period would be reasonable. A longer relationship between the parties would suggest a longer notice period, as long as there have not been repeated defaults. Debtors of good character are entitled to a longer notice period, while those demonstrating dishonest conduct are due only the minimum period. The debtor's ability to raise the necessary money will depend on their assets, inventory, current market conditions, and health of their operations, so an impairment in these elements would favour a shorter notice period. And the narrative that brought the parties to this point, including their discussions before and around the default, will affect what is reasonable notice.

It is important to remember that even a dishonest debtor who appears to us to be insolvent may have funds available through related individuals or corporations. If a creditor demands payment and gives the debtor no time or a very short time to pay, relying on the debtor's inability to raise funds, the creditor risks being unable later to prove that inability.

Perfection of security by PPSA registration

Since the PPSA, in Ontario at least, requires that a lender's security be perfected in order to permit remote disablement of equipment, we had better be clear what it means to achieve perfection. For our purpose, the main elements required are (1) a security agreement signed by the debtor that contains a full description of the equipment, and (2) registration of the security in the PPSA registry.

So my client, if he ever wished to disable customer equipment in the future, should have security agreements signed by those customers to whom he will be extending credit. Then he must register these agreements and in the registration specify the equipment by serial number. And he must always ensure that he has the full and correct spelling of the debtor's name.

The security agreement itself should include, among many other things, details about the technology that will be used for remote disablement, including, for example, whether there will be periodic code updates required for the equipment to continue to operate.

The unpaid debt in one of my client's cases arose from monthly maintenance and service fees that had fallen into arrears. One strategy I use now when I finance this client's customers is to restructure the client's old required monthly service fees into a new, single-fee service contract package that must be purchased up front. We then include this service contract fee as part of the financing.

Other considerations

The technologies available for remote disablement are as varied as the kinds of equipment they disable. Those who employ these technologies must consider, for example, their legality in the various jurisdictions the equipment comes to rest, the impact their use may have on insurance coverage, and the effect a disabled machine may have on its surroundings, on or beyond the debtor's property. Security agreements must also be customized for each technology.

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