

Notice of Assignment of Accounts Receivable Under the PPSA: What Every Factor Should Know

INTRODUCTION

Factoring is the legal relationship between a financial institution (the “Factor”) and a business (the “Client”) selling goods or providing services to a trade customer (the “Customer”), pursuant to which the Factor purchases the accounts receivable owing to the Client by its Customer. The Courts in Ontario have determined that a factoring agreement creates a security interest and, as such, is subject to the provisions of the *Ontario Personal Property Security Act R.S.O. 1990 c.P.10* (the “PPSA”). This means, among other things, that the Factor must register a financing statement against the Client under the PPSA claiming a security interest in the Client’s accounts receivable.

A factoring agreement may be on a notification or a non-notification basis. A factoring agreement on a notification basis requires that the Client’s Customer be notified regarding the purchase of the accounts receivable by the Factor and the assignment of the accounts receivable by the Client to the Factor. One purpose of notifying the Customer is to require the Customer to make payment on the

accounts receivable directly to the Factor, instead of to the Client.

A notice of assignment is governed by Section 40(2) of the PPSA, which states that an account debtor (i.e., the Customer) may pay the assignor (i.e., the Client) until the Customer receives notice, reasonably identifying the relevant rights, that the accounts receivable have been assigned. If requested by the Customer, the Factor is required, within a reasonable period of time, to furnish proof of the assignment and, if the Factor fails to do so, the Customer may pay the Client.

What constitutes adequate notice of an assignment of accounts receivable? The PPSA does not set out a statutory form of notice of assignment. In *RPG Receivables Purchase Group Inc. v. Krones Machinery Co. Limited*, 2010 ONSC 2372, C. W. Hourigan J. of the Ontario Superior Court of Justice was required to review a notification of assignment and to determine whether it was adequate. The Court’s decision is an important guide to the essential elements that should be included in the notice of assignment.



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THE FACTS

The facts were as follows:

1. On July 14, 2005, RPG Receivables Purchase Group Inc. ("RPG") entered into a factoring agreement with its client Kennedy Automation Limited ("Kennedy"), pursuant to which RPG agreed to purchase certain of Kennedy's accounts receivable, including accounts receivable due from its customer Krones Machinery Co. Limited ("Krones").

2. On July 14, 2005, Kennedy faxed a notification of assignment to Krones, which read as follows:

"NOTIFICATION OF ASSIGNMENT

In order to grow and serve you better, we have retained the services of RPG Receivables Purchase Group Inc. to accelerate and stabilize our cash flow. Through their accounts receivable program, RPG has purchased and we have assigned to them all of our right, title and interest in all currently outstanding as well as all future accounts receivable from your company.

We request that all payments be made payable and mailed directly to:

RPG Receivables Purchase Group Inc.
("RPG")

Suite 300, 221 Lakeshore Road East
Oakville, ON L6J 1H7

Tel (905) 338-8777 (800) 837-0265
Fax (905) 842-0242

This notice of assignment and payment instructions will remain in full force and effect until RPG advises you otherwise in writing. Please note that their receipt of payment

is the only valid discharge of the debt and that RPG's interest has been registered under the Personal Property Security Act of the Province of Ontario.

Although this notification is effective upon receipt by you, in order to complete RPG's records, we would appreciate your acknowledgement of this notification and your confirmation that:

- the invoices on the attached statement are for goods and/or services completed to your satisfaction (please note any exceptions or simply provide a listing from your accounts payable); and
- that payments will be scheduled in accordance with the invoice terms and that your accounts payable records have been modified to ensure payment of the full invoice amounts directly to RPG or you will notify RPG of any disputes or potential chargebacks in a timely manner.

Please fax and mail the signed copy of this letter to RPG Receivables Purchase Group Inc., who shall be entitled to rely upon your notification and confirmation as a separate agreement made between you and them. Thanks for your help and cooperation. We look forward to serving you in the future."

3. On August 5, 2006, Krones executed the notification of assignment and returned the executed copy to RPG.

4. In 2007, Kennedy entered into agreements with Krones for the supply of services and materials to Krones in relation to various projects including projects in Etobicoke, Edmonton, and Moncton.

5. Before Kennedy submitted its invoices to Krones, Kennedy provided the invoices to RPG and RPG stamped each invoice as follows:

"NOTICE OF ASSIGNMENT All payments hereunder have been assigned and are to be made directly to:

RPG RECEIVABLES PURCHASE GROUP INC.

221 Lakeshore Road East, Suite 300
Oakville, ON L6J 1H7

Any offsets or claims should be reported to:

(905) 338-8777 Ontario
(800) 837-0265

Fax (905) 842-0242"

6. Krones paid 13 of the 16 invoices issued by Kennedy. RPG did not receive any notice from Krones regarding any disputes, off-sets, chargebacks or claims arising out of the Edmonton or Etobicoke projects.

7. At or about the time that the three unpaid invoices were rendered, Kennedy began to experience difficulty in paying its subcontractors on the Moncton project.

8. When the Moncton project ran into difficulty, Krones stopped making payments on the Edmonton and Etobicoke invoices in a timely fashion.

9. RPG commenced an action against Krones in respect of the unpaid invoices for the Moncton project that RPG had factored.

10. Krones also commenced an action for damages against Kennedy relating to the Moncton project.

11. Krones denied liability in respect of the unpaid invoices on the grounds that it had a right to set-off due to alleged overpayments, chargebacks, and damages relating to the Moncton project. It also raised issues with respect to the validity of the assignment of the invoices by Kennedy to RPG and the validity of the invoices.

12. The Court decided in favour of RPG and granted it summary judgment in the amount of \$183,172.61, plus interest, for payment of the three outstanding invoices.

THE DEFENCE OF SET-OFF

The primary defence of Krones was that it had a valid defence of set-off. In reviewing this defence, the Court referred to the legal principle of “mutuality”. In order to establish a valid claim of legal set-off, there must be mutuality which requires that the debts be between the same parties and that the debts be in the same right. The Court stated that this mutuality is lost where the debt has been assigned to another party (i.e., the Factor), unless the rights to set-off have accrued between the debtor (i.e., the Customer) and the original creditor (i.e., the Client) prior to receipt of the notice of assignment by the debtor. At the

time that the accounts receivable owing by Krones to Kennedy were assigned to RPG, no right of set-off had accrued in respect of the alleged overpayments, chargebacks, and damages relating to the Moncton property. Therefore, Krones had no legal right to set-off, because the mutuality required for this defence was lost when the accounts receivable were assigned by Kennedy to RPG.

The Court also reviewed the purchase order for the Moncton project to see whether it contained a contractual right of set-off. The Court rejected this claim by Krones and found that there was no contractual right of set-off.

Finally, the Court considered the issue of equitable set-off and concluded that it was not available to Krones.

OTHER DEFENCES

In its other defences, Krones took issue with the validity of the invoices and the validity of the assignment by Kennedy to RPG. Krones argued that the notification of the assignment was limited to the invoice attached to the notification of assignment. The Court rejected this argument for three reasons:

1. This argument ignored the clear statement in the notice of assignment that “RPG has purchased and we have assigned to them all of our right, title and interest in all currently outstanding as well all future accounts receivable from your company”.

2. Each of the disputed invoices contained a stamped notification of assignment; and

3. Krones paid RPG directly for 13 of the 16 invoices.

The Court also rejected a number of other arguments raised by Krones in its defence relating to the validity of the invoices.

CONCLUSIONS

In a notification factoring arrangement, a Factor needs to protect its interest in the purchased accounts receivable by giving written notice of the assignment to the Client’s Customer. According to Section 40(2) of the PPSA, the Customer may continue to pay the Client until the Customer receives notice that the accounts receivable have been assigned to the Factor. However, the PPSA does not set out a statutory form of notice, nor does the PPSA deal with any right of set-off that the Customer may claim with respect to the purchased accounts receivable. In general, a Factor can only “step into the shoes” of his Client and assert the same right that his Client has against the Customer. This means that, if the Customer has any right to claim a set-off against the accounts receivable owing to the Client, then the Factor is required to accept the reduction in payment as a result of any legitimate claim asserted by the Customer.

In order to protect its interest in the purchased accounts receivable, the Factor should send a notice of assignment, which when signed by the Customer, should accomplish the

following purposes:

1. it should require the Customer to make payment on the purchased invoices directly to the Factor, instead of to the Client;
2. it should request the Customer to verify the accuracy of the purchased invoices;
3. it should eliminate the Customer's right to claim any set-off or reduction in the amount payable on the accounts receivable in respect of the Client's obligations arising after the delivery of the notice; and
4. It should create an enforceable direct contract between the Factor and the Customer.

Since the notification of assignment in the RPG case has been given the "judicial seal of approval", it is recommended that this form be used by a Factor in Ontario. It is also recommended that the Factor follow the procedure referred to in the RPG case pursuant to which the Customer is requested to acknowledge and confirm the terms of the notification of assignment and return a signed copy to the Factor.

The Court in RPG also referred to the "stamped notification of

assignment" on each of the disputed invoices as one of the reasons for rejecting the Customer's defences. For this reason, it is recommended that this form of stamp also be used by a Factor in Ontario on each factored invoice before the invoice is submitted to the Customer.

If a Factor follows the above procedures, then the Factor should be able to collect from the Customer on the invoice, regardless of what issues arise between the Client and the Customer subsequent to the delivery of the notice of assignment. If the Customer refuses to acknowledge and sign the notice of assignment, then the Factor will have limited recourse against the Customer and will have to make a business decision regarding the risk involved in funding the invoice. Even if the Customer acknowledges and signs the notice of assignment, the Factor will still have to be on the alert for any future disputes between the Client and the Customer. For example, the form of notification used in the RPG case requires the Customer to notify the Factor of "any disputes or potential chargebacks" and the stamp on the invoices in this case requires the

Customer to report "any offsets or claims". If the Customer notifies the Factor about any such disputes, chargebacks, offsets, or claims, then the Factor will also have to evaluate the funding of the invoice.

A properly drafted notice of assignment will put the Factor in a stronger position to resist any reduction in payment claimed by the Customer. As a practical matter, however, the Factor should also try to confirm with the Customer prior to funding an invoice that there are no disputes between the Customer and the Client. This extra step could avoid the time and expense of litigation over the purchased accounts receivable.