Collateral Matters

A Banking Law Newsletter

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Everything You Always Wanted to Know About Bitcoin - But Were Afraid to Ask

By Mathew Goldstein and Liam Tracey-Raymont*

Bitcoin has arrived in Canada!

For those who have been waiting for a primer on the much-discussed virtual currency, this article provides a brief overview and discusses Bitcoin's usage and character as a financial instrument.

What is it?

Bitcoin is an anonymous digital "currency." It can be used by marketplace buyers and sellers as a means of exchange to sell goods and services. It can also be converted to a more traditional form of currency, as well as bought and sold on a Bitcoin exchange.

Purchasing Bitcoins can be risky. The exchange rates fluctuate significantly, and buyers and sellers often disagree about the valuation of the digital currency. Indeed, the sharp spikes and drops in the various Bitcoin exchange rates have been cited as one of the major risks associated with Bitcoin.

Primarily, Bitcoin has been used to purchase services online. However, a number of popular retailers such as Overstock.com[1] and newegg.com[2] are accepting Bitcoin in exchange for physical goods. Ebay is reportedly considering accepting Bitcoin (they do not currently accept it).[3] Smoke Bourbon Bar-B-Q – a brick-and-mortar retailer located on Harbord Street in Toronto – is advertising its acceptance of Bitcoin. Currently, 338 retailers are listed as Bitcoin-accepting merchants on BitCoinada.com.[4]

1 Overstock.com "Bitcoin on Overstock.com" online (2014) www.overstock.com/bitcoin.

2 Newegg.com "Newegg Bitcoin Accepted" online (2014) www.newegg.com/bitcoin.

3 Matthew J. Belvedere, "Bitcoin key to future of online payments: EBay CEO," online (2014) *CNBC* www.cnbc.com/id/101734293.

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Who created it and why?

In 2008, an anonymous developer using the pseudonym Stoshi Nakamoto is said to have invented Bitcoin in order to create a peer-to-peer electronic cash system.

How is digital currency different from traditional currency?

Bitcoin is decentralized, with no central bank or clearing house. Because use is on an anonymous basis, there have been concerns that Bitcoins may be improperly traded – for example, by using a single Bitcoin for multiple

4 Bitcoinada.com "Canada Bitcoin Business Directory" online (Aug 26, 2014) www.bitcoinada.com/directory.

transactions (double dipping). In order to prevent fraud, Bitcoin transactions are recorded through a public ledger (called the block chain) that keeps track of and publicizes every transaction in the Bitcoin community. The public ledger acts as a record of Bitcoin transactions. The block chain is set up in chronological order and is shared amongst all Bitcoin users to keep track of Bitcoin spending.

How are Bitcoins created and circulated?

Bitcoins are created by a complex process of 'mining' accomplished by individuals and companies. Miners devote massive amounts of computing power to solve increasingly difficult mathematical algorithms which confirm waiting transactions and include them in the block chain. In return for tracking and publicizing Bitcoin transactions, miners are rewarded with 25 newly minted Bitcoins per 'block' of transactions they successfully verify in the block chain.

The Bitcoin protocol is designed to ensure that bitcoins are created at a fixed rate, which makes Bitcoin mining very competitive. The system was set up so that no developer or central authority has the ability to manipulate the system to increase their profits. The maximum number of Bitcoins that will ever enter circulation is capped at 21 million. As of July 30, 2014, approximately 13 million Bitcoins had been mined and have an exchange rate of 1 Bitcoin per $568.61 USD.

The Regulatory Landscape in Canada:

In 2013, Canada Revenue Agency ("CRA") declared that it considered Bitcoin to be the equivalent of goods exchanged under a barter system, as opposed to real currency.[5] Nevertheless, retailers must declare revenues from transactions when they accept Bitcoin as a payment method, and if Bitcoins are bought and sold for purposes of investment or speculation, any profits or losses constitute taxable capital gains or losses. CRA has also suggested that income from the mining of Bitcoins would constitute income from a business and proper reporting will be required.

In the Federal Budget for 2014, the federal government announced its intention to adapt certain parts of the *Proceeds of Crime (Money Laundering) and Terrorist Financing Act* (the "Act") in order to specifically deal with digital currencies in general and, in particular, anonymous transactions (known as 'cryptocurrencies'). Under the Act, activities that constitute a "money service business" must comply with extensive reporting requirements and register with the Financial Transactions and Reports Analysis Centre of Canada ("FINTRAC"), in an effort to deter and identify illicit activity.

5 Canada Revenue Agency, "What You Should Know About Digital Currency," online (2013) www.cra-arc.gc.ca/nwsrm/fctshts/2013/m11/fs131105-eng.html.

FINTRAC requires money service businesses to perform identity verification on clients performing certain types of transactions. These transactions include receiving the equivalent of $10,000 or more in cash, selling or cashing the equivalent of $3,000 or more of travelers' cheques or money orders, sending or receiving international money transfers of $1,000 or more, and any transaction suspected of being money laundering or financing for terrorists. Bitcoin businesses that fall into the category of money-services businesses (potentially, Bitcoin exchanges and dealers), will have to implement anti-money-laundering compliance systems and policies. Financial institutions will not be permitted to create bank accounts and maintain client relationships with digital currency businesses unless such businesses register with FINTRAC. Penalties for non-compliance under the Act are significant and include civil and criminal penalties.

The Effects of Regulation:

On June 19, 2014, the omnibus budget implementation bill received Royal Assent and reporting requirements for money services business became law. The bill refers only to dealers of virtual currency, and not to Bitcoin specifically; however, commentators are suggesting that the new reporting requirements will likely apply to Bitcoin exchanges and other businesses related to Bitcoin production.[6] It is not yet clear how the new regulations will impact retailers accepting Bitcoins as payment, if at all. A consultation paper concerning the new laws will need to be released, along with draft regulations, before Bill C-31 comes into effect.[7]

As money services businesses, dealers of Bitcoins will be required to keep records and identify customers, thus removing the anonymity of a Bitcoin transaction. While some smaller Bitcoin businesses may view regulation as an unwanted interference and expense, others suggest the new regulations may help Bitcoin business to more easily form banking relationships.[8]

Initially, these new regulations may not seem overly stringent. However, in a nascent and volatile industry, increased startup costs related to regulatory complexes may deter the emergence of new Bitcoin businesses and reduce the speed of the digital currency's dissemination and use throughout Canada. On the other hand, if regulation increases the stability and transparency of the Bitcoin system, it may drive new demand for Bitcoin and increase its availability as an alternative means of purchasing goods and services.

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6 Brad Edwards, "What is a Virtual Currency Dealer?" online: (2014) *The Coin Front* www.thecoinfront.com.

7 Christine Duhaime, "Canada Implements World's First National Bitcoin Law," online (2014) *Duhaime Law Notes* www.duhaimelaw.com/2014/06/22/canada-implements-worlds-first-national-bitcoin-law.

8 Victoria van Eyk, "What Canada's New Regulations Mean for Bitcoin Businesses." online: (2014) *Coin Desk* www.coindesk.com.

Domain Name Security Interests: "Control" Isn't "Perfection"

By: Alyssa Keon and Jeremy Nemers

Introduction

As a great deal of value can stem from a debtor's domain name, secured creditors ought to consider how best to protect their interest in such property. One option, which has gained traction in the United States, is to take constructive possession or "control" of the domain name. This means doing whatever is necessary technologically at the time credit is advanced to ensure that no further consent of the debtor would be required, should default occur, to dispose of the collateral. An example would be obtaining and modifying all requisite passwords in the domain name as a condition of providing credit.

While this "control" method has a certain practical appeal, it is woefully inadequate in offering legal protection to secured creditors in the event of a priority dispute. All security interests in personal property – including those in domain names – must be properly perfected to form legal priority over competing secured creditors, trustees in bankruptcy and other *bona fide* stakeholders. A secured creditor obtains a security interest over domain names through a general security agreement or a more specific intellectual property security agreement. The security interest granted in favour of the secured creditor in the intellectual property is then perfected by registering it in Ontario's Personal Property Security Registration System (the "**PPSRS**"). Similar requirements are in place in the other Canadian and U.S. common law jurisdictions.[1]

Domain Names Are Intangible Personal Property

The 2011 Ontario Court of Appeal decision in *Tucows.com Co. v. Lojas Renner S.A.*, for which leave to appeal to the Supreme Court of Canada was refused, confirms that domain names are not only personal property, but are intangible personal property.[2] While this case did not involve security interests in domain names – indeed, there appears to be limited Canadian jurisprudence on this particular topic – the implications of domain names being classified as intangible personal property are two-fold:

i. they are subject to the rules of the *Personal Property Security Act* (Ontario) (the "**PPSA**");[3] and

ii. they are subject to the PPSA's specific rules pertaining to intangible personal property.

Neither Possession Nor Control Perfects Security Interests in Intangible Personal Property

While security interests in personal property under the PPSA may generally be perfected by possession, control or PPSRS registration, intangible personal property may only be perfected via registration.

Perfection by possession requires actual physical possession of the underlying asset, and is statutorily limited to the five categories of *tangible* property – chattel paper, goods, instruments, negotiable documents of title, and money.[4] The PPSA explicitly excludes each of these categories from the scope of intangible property.[5]

Perfection by control is akin to constructive possession of the underlying asset, but this method is statutorily limited to "investment property" such as shares or futures contracts, and typically involves the execution of an agreement by which the issuer or broker agrees to comply with instructions given by the secured creditor.[6] Once again, the PPSA explicitly excludes "investment property" from the scope of intangible personal property.[7]

Given the factual impossibility of physically possessing intangible assets, it makes perfect sense that perfection by physical possession not be available to security interests in such assets. However, the rationale for restricting the control method is not as clear. In essence, a secured creditor that attains control has done whatever is necessary, given the circumstances, to be in a position to dispose of the property without further consent of its

1 In the United States, for example, see UCC § 9-312 to § 9-314.
2 2011 ONCA 548, 106 O.R. (3d) 561, 336 D.L.R. (4th) 443, leave to SCC refused, 34481 (May 24, 2012) at paras. 65-66.

3 R.S.O. 1990, c. P.10, as amended [PPSA].
4 *Ibid*, s. 22.
5 *Ibid*, s. 1(1) ("intangible").
6 *Ibid*, s. 22.1; see also *Securities Transfer Act, 2006*, S.O. 2006, c. 8, ss. 23-25.
7 *Supra* para. 3, s. 1(1) ("intangible").

original owner. If this can be achieved with "investment property" by instructing the issuer or broker of shares to comply with instructions given by the secured creditor instead of the original owner, it is not clear why this method ought not to be applied in the domain name context to establish valid perfection. The short answer for the time being is that the control method does not apply to domain names because the PPSA does not allow for it.

PPSRS Registration is the Only Way to Perfect Security Interests in Intangible Personal Property

This leaves the PPSRS registration method as the only avenue through which security interests in domain names may be perfected. The PPSA explicitly provides that "[r] egistration perfects a security interest in any type of collateral."[8] This refers to the registration of a financing statement with the PPSRS, and not some other registry. Consequently, while a secured creditor may "record" its security interest elsewhere – such as with the Canadian Intellectual Property Office ("**CIPO**") for trademarks, patents, industrial designs and copyrights (no domain name registry is maintained by CIPO) – the secured creditor still needs to register its security interest under the PPSA to properly perfect its security interest. Should a priority dispute arise with respect to properly-perfected and competing security interests in the same domain name, only the temporal order of registration under the PPSRS will determine the winner.[9]

Conclusion

Although the PPSA's perfection rules for intangibles have yet to be brought before the courts in the domain name context, the statutory regime appears to be quite clear that security interests in domain names can only be perfected by registration under the PPSRS. Thus, while it is entirely possible for a secured creditor to maintain *practical* control of a domain name, this should not be confused with *legal* protection and the requirements of the PPSA. A secured creditor that does not register its security interest in a domain name under the PPSRS will be vulnerable should a priority dispute arise. Where a domain name forms an integral part of the security package, a prudent secured creditor may want to register its interest under the PPSRS and obtain control of the domain name.

8 *Ibid*, s. 23.

9 PPSA, *supra* para. 4, s. 30(1).

ABCs vs VINs: Which governs Security Registration Errors?

By Brett Kenworthy

The underlying purpose of each provincial Personal Property Security Registration System is to provide notice to subsequent creditors of existing security interests. Financing statements that are registered by creditors should provide accurate information in the required format. However, what happens when a creditor registers against a motor vehicle and provides an incorrect debtor name, but the proper vehicle identification number ("**VIN**")? Can this registration serve to perfect a security interest? The Newfoundland Supreme Court Trial Division's (the "**Court**") decision in *Hoskins, Re*[1] ("**Re Hoskins**") underlines the challenge to strictly apply registration requirements, while also sustaining the spirit of the law and purpose of the notification process.

Re Hoskins

Edgar Thomas Geoffrey Hoskins, as indicated on his birth certificate, signed a conditional sales agreement (the "**Agreement**") to buy a Honda Civic in 2010. The Agreement showed his name to be Thomas Edgar Hoskins, as provided by Mr. Hoskins' inaccurate government-issued driver's licence. The Agreement was assigned from an undisclosed dealership to Honda Canada Finance Inc. ("**Honda**"), the financing corporation associated with the dealership, which registered a financing statement using this incorrect name, along with Mr. Hoskins' date of birth and the VIN.

Three years later, Mr. Hoskins filed an assignment in bankruptcy, pursuant to which the court-appointed trustee-in-bankruptcy (the "**Trustee**") performed a search of the Newfoundland and Labrador Personal Property Registry in Mr. Hoskins' true name. The Trustee's search did not reveal Honda's registration made against the inaccurate name provided by Mr. Hoskins' driver's licence; however, the Trustee also performed a search against the VIN of Mr. Hoskins' Honda Civic and it located the registration against the incorrect name of "Thomas E. Hoskins." The Trustee nevertheless disallowed Honda's security interest claim in the Honda Civic, instead allowing Honda's claim as an unsecured claim.

At paragraph 12 of its decision, the Court noted the Trustee's position that, while it was aware of the

1 2014 NLTD(G) 12, 8 C.B.R. (6th) 98, [2014] N.J. No. 21 [**Re Hoskins**].

security interest, the security in the immediate case was "unperfected according to the legislation, and…therefore ineffective as against the trustee."[2] The Court agreed, holding at paragraph 32, that "…the personal property security regime promotes clarity and certainty and moves away from concepts such as constructive notice and unfairness. The rules are precise. Accuracy is expected. Those relying on the registration system to search for prior security interests are entitled to expect that those filing financing statements will respect the prescribed rules."[3]

Ontario requirements for VIN Registrations

This case would have likely had a different result in Ontario, as its *Personal Property Security Act*[4] (the "**PPSA**") differs from its counterpart in Newfoundland and Labrador. Pursuant to subsection 46(1) of the PPSA, "[a] financing statement or financing change statement that is to be registered shall contain the required information presented in a required format."[5] However, flexibility is provided through a cure provision at subsection 46(4) of the PPSA, as "[a] financing statement or financing change statement is not invalidated nor is its effect impaired by reason only of an error or omission therein or in its execution or registration unless a reasonable person is likely to be misled materially by the error or omission." As will be described below, the Ontario courts have found that a reasonable person is not likely to be materially misled by an error in the debtor's name if the VIN is accurately set out in that same financing statement.

Re Lambert

A leading Ontario case on the application of subsection 46(4) of the PPSA with respect to a security registration made against an incorrect debtor name, but containing an accurate VIN, is the decision of the Ontario Court of Appeal (the "**Court of Appeal**") in *Lambert, Re*[6] ("**Re Lambert**"). In this matter, a registration of a security interest in a motor vehicle contained inaccuracies with a debtor's first given name and the initial of the second given name, but included the correct VIN. In this case, the trustee did not have actual knowledge of the security interest and the search of the debtor's name did not disclose the security interest. A VIN search was not performed, but had a VIN search been conducted, it would have revealed the security interest. The court at first instance held that subsection 46(4) of the PPSA did not serve to cure the error in the debtor's name. However, the Court of Appeal allowed the appeal and inferred that the legislature intended an objective test, pursuant to its inclusion of a reasonable person standard.[7] In the case of motor vehicle registrations, the Court of Appeal held:

> "…where motor vehicles are involved, the integrity of the registration system does not depend only on accurately recording the debtor's name in the financing statement. Indeed, the V.I.N. search function exists specifically because a name-dependent system for motor vehicles would be inadequate and would leave potential purchasers and lenders vulnerable to encumbrances placed on the motor vehicle by prior owners of the motor vehicle. In the case of motor vehicles, the registration system is not name-dependent. Rather, it provides for identification of prior registrations by the combined access to the system afforded by name and V.I.N. searches."[8]

The Court of Appeal concluded that where the property is a motor vehicle, the reasonable person will conduct both a specific debtor name search and a VIN search.[9] Accordingly, a reasonable person would not likely be misled materially by an error in a financing statement relating to the debtor's name if that same financing statement accurately provided the VIN.[10]

Conclusion

As can be seen, provincial Personal Property Security Registration Systems can vary with respect to the latitude provided for inadvertent errors. Adhering to the letter of the law is of paramount importance to ensure that the intended security registration is properly perfected. Clearly, the best practice is to register accurate information in the required format. Accordingly, before registering, creditors should double-check that all information included in the registration is accurate and should both conduct and review post-registration searches to confirm that registrations contain accurate information.

2 *Ibid.* at para. 12.
3 *Ibid.* at 32.
4 R.S.O. 1990, c. P.10.
5 *Ibid.* at subs. 46(1).
6 (1991), 2 P.P.S.A.C. 160, 11 C.B.R. (3d) 165 (Ont. Bktcy.), rev'd (1994), 7 P.P.S.A.C. (2d) 240, 28 C.B.R. (3d) 1 (Ont. C.A.), add'l reasons at 1995 CarswellOnt 4269, 22 O.R. (3d) 480 (Ont. C. A.), leave to appeal ref'd [1994] S.C.C.A. No. 555, 23 O.R. (3d) xvi (note) (S.C.C.).
7 *Ibid.* at para. 30.
8 *Ibid.* at para. 42.
9 *Ibid.* at para. 45.
10 *Ibid.* at para. 47.

Did You Get What You Paid For? The Exercise of Judicial Discretion when Assessing Professional Fees in a Bankruptcy and Insolvency Context

By Brett Kenworthy and Mark Strychar-Bodnar*

Bankruptcy and insolvency professionals should take note of two recent Ontario Superior Court decisions that put professional fees in the spotlight. *TNG Acquisition Inc.* (Re), 2014 ONSC 2754 [Commercial List] ("**TNG Acquisition**") and *Bank of Nova Scotia v. Diemer*, 2014 ONSC 365 ("**Diemer**"), saw Brown J. and Goodman J., respectively, reduce fees for court-appointed officers and their legal counsel on the basis that the amounts sought were unreasonable in consideration of the work performed. This exercise of judicial discretion signals a shift that the courts are live to this issue, and are increasingly willing to scrutinize the fees of court officers and their counsel. This article identifies the key takeaways from these recent decisions and offers practical advice for lawyers and court-appointed officers.

Principles for the Approval of Fees:

Diemer and *TNG Acquisitions* demonstrate the exercise of judicial discretion when assessing the fees of court-appointed officers. This exercise of judicial discretion is guided by principles of reasonableness and fairness. In *Bakemates International Inc.* (Re), [2002] O.J. No. 3569 (Ont. C.A.), the Ontario Court of Appeal held that the onus is on a receiver to demonstrate that the amount of its fees are fair and reasonable when the court's approval of its fees is sought. Further, in *Belya v. Federal Business Development Bank*, [1983] N.B.J. No. 41 (N.B.C.A.), the New Brunswick Court of Appeal held that a receiver's compensation must be a fair and reasonable measure of its services, and that those services should be administered as economically as possible.

Diemer:

In *Diemer,* a January 2014 decision, the court-appointed receiver and its legal counsel ("**Counsel**"), sought an order approving the fees and disbursements of Counsel in the amount of $255,955. In reducing this amount to $157,500, Goodman J. held that, notwithstanding the initial receivership order permitting Counsel to charge its standard rates, the fees charged were not appropriate given the simple nature of the receivership.

Goodman J. took several factors into consideration. First, the nature and extent of the value of the assets handled should have a linear relationship with the fees sought: in general, the lower the value of the assets, the lower the cost of administering the assets. Second, Goodman J. considered whether there were complications or difficulties encountered during the receivership, as this would provide support for a claim for higher costs. Third, Goodman J. considered the cost of comparable services when performed in a prudent and economical manner. In this respect, Goodman J. noted that legal fees from London-area lawyers are lower than their colleagues in Toronto, and since this receivership was administered in the London area, a representative London rate should be used for the comparison of the claim for Counsel's fees.

Of interest, Goodman J. also commented that Counsel had not updated the court on its accrued costs generated supporting the receiver in administering the receivership. Goodman J. noted that while there is no obligation for Counsel to routinely seek the court's approval for its fees, it would be prudent to do so in matters where costs are running high relative to the value of the assets being administered. Goodman J. also took issue with the fact that senior partners did not delegate sufficiently in what he regarded as a simple matter, where junior lawyers or staff could have competently performed the necessary work. Finally, Goodman J. commented that red flags are raised when too many lawyers are charging on one file, especially when it is a straightforward receivership.

It must be noted that the decision of Goodman J. is currently under appeal.

TNG Acquisition:

In *TNG Acquisition,* a May 2014 decision, a trustee in bankruptcy (the "**Trustee**") sought an order authorizing the former Chief Restructuring Officer to distribute costs to

the company's monitor (the "**Monitor**"), appointed under the *Companies' Creditors Arrangement Act* (Canada), and the Monitor's legal counsel. The costs were associated with the Trustee's request about certain events which took place during the Monitor's term and the retrieval of related documentation. Brown J., of the Commercial List, referred to this task as an "archive-retrieval request."

While Brown J. found that the time spent to obtain, review and deliver the documentation was reasonable, the fees charged for such work were not. He referred to the court's discretion to review the reasonableness of the fees charged and significantly reduced the amount to be distributed.

Specifically, Brown J. took issue with the seniority and rates of professionals tasked to complete the work. He held that if a partner or senior manager elects to perform work of a clerical or administrative nature, then he or she should bill at clerical or administrative rates. Counsel's fees of over $800/hour, when "measured against the simplicity of the request," were held to render the submitted costs unreasonable.

Further, the Monitor's charge of 9% of total costs, allocated to cover "administrative expenses," was found to be unreasonable. Brown J. held that administrative costs are generally contemplated in the hourly rates of professionals and both the Monitor and its counsel's costs were significantly reduced.

Practical Application of Diemer and TNG Acquisition:

The courts have demonstrated an active willingness to exercise discretion in the approval of fees claimed in respect of bankruptcy and insolvency matters. Accordingly, professionals in this field should keep the following in mind:

First, be careful and precise when preparing and providing information contained in fee affidavits. That goes for both legal counsel, as well as other professionals submitting accounts for approval.

Second, ensure that work is performed by individuals with the appropriate skill level and billing rates for a particular task. In short, delegate to the appropriate person for the task. Clerical and administrative tasks should not be performed by senior professionals, or, in the event that timelines or other factors necessitate that this work be performed by a more senior professional, appropriate rates that reflect the level of skill required for the work performed should be applied.

Third, pass fees regularly as the file progresses, rather than waiting until the end of the matter to seek approval of professional fees.

Fourth, the practice of allocating administrative expenses as line items in invoices to account for general overhead expenses may need to be revised or eliminated. Brown J. noted that 9% of total costs is unreasonable and should instead be reflected in the hourly rates charged. Professional services providers may need to review the manner in which these costs are defrayed in order to ensure that they can be recaptured without the possibility that the courts will refuse to accept such costs.

Finally, geographic location (for the purposes of generating comparative local professional fees) and the nature of the proceedings are factors that will be considered when fees are reviewed in order to determine whether the assets are being administered as economically as possible.

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