

National Banking Law Review

General Editor: Robert E. Elliott, Fasken Martineau DuMoulin LLP

VOLUME 29, NUMBER 1

Cited as 29 Nat. B.L. Rev.

FEBRUARY 2010

• THE NEW REGULATION UNDER THE ACT RESPECTING INSURANCE IS NOW IN FORCE. WHAT'S NEW? •

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On August 26, 2009, the Québec government published the *Regulation under the Act respecting insurance* (the “Regulation”). Most of the provisions of this Regulation came into force September 10, 2009. These changes will significantly rejuvenate the previous implementing regulation that was first adopted in 1976, and was subsequently amended many times over the years (the “Previous Regulation”). The Regulation introduces few new subjects, although it makes major changes to some of the principles that have applied until now. This article will summarize the principal changes.

CONSTITUTION, CONTINUANCE AND AMENDMENT OF THE ARTICLES OF INSURANCE COMPANIES

A number of clarifications have been made to the formalities that apply to the constitution of insurance companies, mutual insurance associations, federations of mutual insurance associations and guarantee funds. The same also holds for amendments to the articles of insurance companies and their continuation under Part IA of the *Companies Act* (Québec).¹ The fees payable to the Autorité des marchés financiers and/or the Québec Minister of Revenue in respect of these measures have also been increased (ss. 1 to 10 of the Regulation).

CLASSES OF INSURANCE

It is the Regulation that lists the classes of insurance for which insurers may obtain licenses in Québec under s. 201 of the *Act respecting insurance* (Québec) if they are to be authorized to engage in insurance activities.²

Here are some of the amendments that were made:

- the “accident and sickness insurance” class has been broadened and now provides for payment of an indemnity in the event of bodily injury including death, resulting from an accident sustained by an insured, the payment of an indemnity in the event of sickness or disability of an insured, and now specifies that reimbursement for expenses incurred for the health care of an insured are now also included in this insurance class (s. 14 of the Regulation);
- The Regulation simplifies the description of the “property insurance” class to provide that it contemplates insurance that indemnifies against loss of or damage to property, to the extent that the insurance does not cover property that is more specifically covered by another class of insurance (s. 17 of the Regulation). You may perhaps remember that this class of insurance previously contained an exhaustive list of the types of insurance included in this class. The following more specific classes were explicitly targeted: livestock insurance, immovable property insurance, moveable property insurance, plate glass insurance, impact by vehicles insurance, falling aircraft insurance, water damage insurance, explosion insurance, forgery insurance, sprinkler leakage insurance, limited hail insurance, fire insurance, weather insurance, civil commotion insurance, windstorm insurance, transportation insurance, earthquake insurance and theft insurance;³
- the description of the “boiler and machinery insurance” class has been amended to increase its scope; among other things, it specifically indemnifies the insured against material loss or damage sustained by the insurer by reason of the explosion or rupture of a boiler or any other pressure vessel or resulting from an accident in the course of its operation, as well as any liability arising out of bodily injury or damage to property caused by the same events. This class now also authorizes the indemnification of insureds against material loss or damage sustained by reason of the use, breakage or breakdown of machinery (s. 18 of the Regulation);
- what was formerly known as the “guarantee insurance” class, which covered surety insurance and fidelity insurance, has now disappeared and been replaced by two separate insurance classes, namely “surety insurance” and “fidelity insurance” (s. 19 of the Regulation);⁴
- the “fidelity insurance” class has been broadened to indemnify not only against loss resulting from theft, embezzlement or breach of trust committed by an employee, but also committed by an agent, a mandatary, a partner, an officer or a member; it now also includes indemnification of insureds should any of those persons mentioned above fail to perform duties or perform them inappropriately (s. 23 of the Regulation);
- the “credit protection insurance” class is new; it seeks to indemnify a creditor against loss resulting from failure, on the part of an insured natural person owing a debt to the creditor, to repay the latter by reason of insufficient income up to the amount of the debt; however, it specifically excludes the protection included in hypothec insurance or credit insurance; credit insurance seeks to indemnify insured creditors against loss resulting from failure on the part of debtors to repay the insured creditors, and does not include protection for claims secured by hypothec (s. 20 of the Regulation);
- the “hypothec insurance” class has been broadened to indemnify an insured creditor against loss resulting from failure on the part of a debtor to repay not only a loan secured by an immovable hypothec, but also secured by a moveable hypothec (s. 22 of the Regulation);
- “fire insurance” has been added as a separate class; in addition to indemnifying insureds against the loss or damage that is the direct consequence of fire or the burning of insured

property, this class now targets damage that is the direct consequence of fire or the burning of insured property during transportation or resulting from the methods used to extinguish the fire (s. 26 of the Regulation);

- the “title insurance” class is drafted in far broader terms than previously, seeing as it now indemnifies insureds against (i) loss or damage resulting from a defect in the title to property; (ii) the existence of a hypothec, a prior claim, a servitude or any other restriction on the right of ownership of property; (iii) a defect in a document that evidences a hypothec, a prior claim, a servitude or a restriction on the right of ownership of property and (iv) any other situation affecting title to property or the existence of another real right, including the right to the enjoyment of property (s. 28 of the Regulation);
- the “marine insurance” class has also been broadened to cover, in addition to the financial consequences of liability arising out of bodily injury or damage to property arising out of or related to shipping by sea or inherent to such transportation, the risks of an adventure analogous to a marine adventure, land risks incidental to a marine adventure and risks incidental to the building, repair and launch of ships (s. 29 of the Regulation).

COMMERCIAL PRACTICES AND DISCLOSURE OF CONDITIONS OF INSURANCE CONTRACTS

The Previous Regulation contained a number of sections on the standards that apply to the disclosure of conditions of insurance contracts in general advertising. The Regulation now limits itself to four sections. Despite the restricted number of provisions contained in the Regulation, the *Autorité des marchés financiers* can be expected to fill some of the voids with its policy on commercial practices that should be published in the coming months. Remember, too, that some provisions of the *Consumer Protection Act* (Québec)⁵ also apply to insurance and annuity contracts, specifically as they pertain to the provisions of that act regarding commercial practices.

The provisions of the Regulation that contemplate commercial practices and the disclosure of conditions of insurance contracts are set forth in ss. 34 to 37, and read as follows:

34. Insurers must present themselves under their true identity and not use a phrase that could cause confusion, particularly as regards trademarks or service marks, slogans, symbols or any other identification marks.

35. An insurer may not, in any insurance offer, exaggerate the extent of the protection offered or the amount of payable benefits, nor minimize the cost thereof.

Except in its advertising, an insurer must also specify the exclusions likely to affect the nature or scope of the protection under the contract. The insurer must also expose any limitation resulting from a waiting period.

Upon renewal, cancellation or termination of a contract, the insurer must refer to the relevant provisions in the contract.

36. An insurer advertising that no prior medical examination is required under the contract must specify whether the stipulation applies to the insurance application only, or also to the payment of benefits. The insurer must also indicate the limits to protection under the contract in the case of death, illness or disability resulting from conditions existing prior to the effective date of the insurance.

37. No insurance offer may falsely claim or suggest that the insurance offered constitutes special protection and that the policyholder will be able to benefit from certain additional advantages if the insurance is taken out, or that the insurance is limited to a determined group of persons.

Section 34 of the Regulation does not specify, as did the Previous Regulation in its s. 250, that it is only in the context of advertisement that insurers must establish their real identity. It is now up to the insurers to present themselves under their true identity without using any additional qualifiers. Note that, contrary to what was the case in the first version of the Regulation, the words “in all circumstances” were omitted in the final version adopted by the government, which required insurers to present themselves “in all circumstances” under their true identity.

INVESTMENTS

The Regulation has considerably expanded the scope of investments representing more than 30 per cent of the assets or the voting rights of a legal person that an insurer or its subsidiary can make.

Section 244.1 of the *Act respecting insurance* (Québec) provides that an insurer other than a mutual

insurance association may not acquire, directly or through a partnership or legal person it controls, more than 30 per cent of the assets or the voting rights attached to the shares of a legal person, a cooperative or other similar legal person whose head office is situated outside Québec.

A similar provision also applies to mutual associations.

However, an exception set forth in s. 244.2 of the *Act respecting insurance* (Québec) stipulates that an insurer may acquire directly all or part of the shares (i) of a legal person that only carries on activities similar to those the insurer is authorized to carry on and (ii) of a legal person who complies with the conditions set forth in the Regulation.⁶

The Regulation now provides, in ss. 38 and 39, that an insurer may acquire the shares of a legal person (i) whose principal activity is the purchase, management, sale or leasing of immoveables; (ii) whose principal activity is the offering of shares in investment portfolios, the making of loans and investments, factoring, leasing, the offering of computing services or actuarial advisory services; (iii) whose principal activity is complementary to the distribution of certain insurance products such as travel assistance, legal assistance and road assistance; (iv) whose activities are those of a firm within the meaning of the *Act respecting the distribution of financial products and services* (Québec)⁷ or that offers financial products and services outside Québec.

Moreover, an insurer other than a mutual insurance association may acquire all or any of the shares of a legal person operating a residential and long-term care center.

Finally, s. 40 of the Regulation also authorizes an insurer's subsidiary to acquire more than 30 per cent of the voting shares issued by a legal person if (i) the legal person's principal activity is the purchase, management, sale or leasing of immoveables, (ii) the legal person's principal activity is the offering of shares in investment portfolios, the making of loans and investments, factoring, leasing, or the offering of computing services or actuarial advisory services; (iii) the legal person's principal activity is complementary to the distribution of certain insurance products such as travel assistance, legal assistance and road assistance; or (iv) the legal person is an insurer, a bank, a trust company, a savings company, a firm within the meaning of the *Act respecting the distribution of financial products and services* (Québec), a securities dealer or

advisor, or is a legal person that offers financial products and services outside Québec.

ACTIVITIES OF A TRUST COMPANY

Section 44 of the Regulation specifies the activities of a trust company that an insurance company holding a licence issued under the *Act respecting insurance* (Québec) is authorized to carry on. While the Previous Regulation contained no equivalent reference, s. 33.2.1 of the *Act respecting insurance* (Québec) provides that an insurance company may also carry on the activities that only a trust company may carry on under the *Act respecting trust companies and savings companies* (Québec)⁸ that are authorized by a government regulation. The activities set forth in the Regulation are (i) acting as trustee for any retirement plan, retirement savings plan, education savings plan, disability savings plan or any other plan, fund or mechanism of the same nature administered by the insurance company and registered under the *Taxation Act* (Québec)⁹ or the *Income Tax Act* (Canada),¹⁰ (ii) acting as trustee of an investment fund within the meaning of the *Securities Act* (Québec)¹¹ administered by the insurance company and (iii) the activities that a trust company may carry on under the *Act respecting trust companies and savings companies* (Québec) in respect of the annuity contracts administered by the insurance company and the insured amounts kept by it for the benefit of others.

INVESTMENTS IN LEGAL PERSONS CONTROLLED BY AN INSURER TRANSACTING DAMAGE INSURANCE

Investments in legal persons controlled by an insurer transacting damage insurance must henceforth be valued on an equity basis rather than the basis applicable to the unconsolidated annual statements (s. 51 of the Regulation).

SEPARATE FUNDS

The Regulation now specifies that the assets of separate funds maintained by an insurer transacting insurance of persons and contracting obligations that vary according to the market value of a specified group of assets must now be valued in accordance with generally accepted accounting principles rather than at their fair market value (s. 52 of the Regulation).

GROUP INSURANCE OF PERSONS

The Regulation makes several amendments to the provisions of the Previous Regulation on group insur-

ance of persons. Our goal here is not to delve into all of the amendments made, but only the most important ones. However, any insurer offering group life insurance or group sickness or accident insurance should carefully examine the applicable provisions of the Regulation. These will specifically have an impact on the product features offered by an insurer, on the actuarial risks and, consequently, on premiums.

CONDITIONS APPLICABLE TO CONTRACTS FOR GROUP INSURANCE OF PERSONS

The Regulation now provides for similar requirements as in the Previous Regulation respecting the criteria used to determine what a specified group of persons is for the purposes of group life, sickness or accident insurance. However, the Regulation adopts far more flexible wording than did the Previous Regulation. A group is now defined as a group whose members share common activities or interests before a group insurance plan is offered to them, including socio-economic or cultural interests, and that a specified group of persons may not be constituted for the sole purpose of entering into a group insurance contract, and group insurance may be offered to the members of a group only as a benefit complementary to membership (s. 60 of the Regulation). The Previous Regulation introduced very specific criteria respecting the years of the body's existence, the annual assessment charged to its members and the holding of annual meetings.

The Regulation specifies that if the policyholder is an association of employees or a professional syndicate, it may enter into an agreement with the employer or a third party so that the employer or third party person may manage the master policy in the name of the policyholder (s. 61 of the Regulation). The Previous Regulation does not provide for any exception to the principle that the policyholder of a group insurance contract must be able to provide for the management of the master policy, as well as for the collection and remittance of premiums (also s. 61 of the Regulation).

Under the Regulation, insurers may pay policyholders of a group insurance on life or health contract no remuneration other than reimbursements for expenses actually incurred to administer the contract. Such expenses may not be calculated as a percentage of the premiums or be otherwise associated with the premiums, except in the case of expenses incurred for the collection of premiums. Such a restriction seeks to prevent policyholders from being incited, by reason of

the financial compensation they receive, to unduly insist that members of a particular group take out the insurance (s. 85 of the Regulation). Under the Previous Regulation, ss. 259 and 292 that applied to group life insurance contracts and group life or health insurance contracts of debtors, respectively, prohibited insurers from paying compensation to the policyholder of a group life insurance contract, his representative or a person insured under a master policy for the solicitation or negotiation of insurance, or reimburse any part of the expenses incurred for the collection of premiums in excess of five per cent of the premiums collected from participants.

CONVERSION OF A GROUP LIFE INSURANCE CONTRACT

The participants' rights to convert a group life insurance contract into an individual life insurance contract, which apply when they cease to belong to the group before age 65, are preserved under the Regulation. However, the maximum amount of protection that the participant may convert rose from \$200,000 to \$400,000, while the minimum amount of protection that may be converted rose from \$5,000 to \$10,000. For the participants' family members, the minimum amount of protection that may be converted is \$5,000, although this cannot exceed the amount of insurance on the life of those persons on the conversion date. This conversion option does not apply to sickness or accident insurance incidental to the life insurance contract (s. 62 of the Regulation). As was the case in the Previous Regulation, this right may be exercised by the participant within 31 days after leaving the group, without the participant having to provide evidence of insurability, including for the family and dependants.¹²

Section 63 of the Regulation no longer restricts the products that insurers may offer participants who leave the group. Insurers must now offer either of the following options: (i) individual life insurance, temporary or permanent, at the participants' option, providing protection comparable to that provided under the group insurance contract both as to amount and term, or (ii) individual life insurance for one year, providing protection comparable to that provided under the group insurance contract, but convertible at the end of the year, at the participant's option, into the insurance described in para. (i) above (see s. 63 of the Regulation and ss. 262 and 263 of the Previous Regulation).

Provisions also apply to the conversion of any group life insurance protection into an individual life

insurance of participants who have been insured for at least five years, upon expiry of the master policy, if the latter is not replaced or the replacement contract provides for a lesser amount of insurance. In such a case, the amount of insurance that may be converted must be no less than \$10,000 (that amount was formerly \$5,000) or 25 per cent of the amount of the participant's life insurance on the expiry of the master policy, whichever amount is greater. The sections that otherwise apply to the conversion of group life insurance protection of participants who cease to belong to the group also apply to conversions that take place upon the expiry of the master policy (s. 66 of the Regulation).

COMPULSORY CLAUSES IN GROUP LIFE INSURANCE CONTRACTS

Group life, sickness or accident insurance contracts must provide for maintenance of the protection after their expiry or the cancellation of any contract protection if the claim arises from an event that occurred while the contract was still in force (s. 68 of the Regulation).

Under the Regulation, insurers are now bound for 180 days, up from the previous 90 days, to compensate participants in the event of a recurrence of the disabling affliction as long as they are not covered under another contract (s. 70 of the Regulation).

Similarly, the Regulation also increases from 90 to 180 the number of days that must have elapsed since the due date of the last benefit or the last premium for which there was a waiver and the beginning of the new disability period, preventing participants in a new contract from being exempted from any waiting period if the new disability period is attributable to the same or related causes that gave rise to the payment of benefits under the former contract (s. 73 of the Regulation and s. 271 of the Previous Regulation).

Extending this period from 90 to 180 days will certainly have a major impact on the evaluation of insurers' actuarial risks and, eventually, on premiums.

CONDITIONS APPLICABLE TO GROUP INSURANCE CONTRACTS ON THE LIFE OR HEALTH OF DEBTORS AND ON THE LIFE OF DEPOSITORS

Section 75 of the Regulation, despite being based on an equivalent provision of the Previous Regulation, introduces new principles. It reads as follows:

75. In group insurance on the life or health of debtors and on the life of depositors, the enrollment form or loan agreement must indicate the premiums required to cover all or part of the cost of the life insurance or sickness or accident insurance. If the cost of the premiums is determined by a rate of interest added to the rate of interest for the loan, the enrollment form or loan agreement must indicate the percentage of added interest that constitutes the premium.

All questions or limitations regarding state of health as a condition of eligibility must be clearly specified on the enrollment form.

The policyholder must, at the time the enrollment form is signed by the participant, give a duly completed and signed copy of the form to the participant.

Any form used in the policyholder's business that contains an application for insurance constitutes an enrollment form."

Section 282 of the Previous Regulation, the equivalent of s. 75 in the Regulation, did not apply to savings and credit unions (s. 283 of the Previous Regulation). Another important amendment set forth in s. 75 of the Regulation that applies to group insurance on the life or health of debtors and on the life of depositors is that if the cost of the premiums is determined by a rate of interest added to the rate of interest for the loan, the enrolment form for the insurance must now indicate the percentage of added interest that constitutes the premium.

The Regulation further specifies, where the Previous Regulation was mute, that a creditor may underwrite insurance on the life or health of persons other than the debtor, but only if the creditor has a pecuniary interest in their life or health (s. 76 of the Regulation).

Section 77 of the Regulation, also new, specifies that a creditor does not cease to act as the policyholder by reason of the assignment of the claim to a third person. Under such circumstances, the amount payable under the contract must be paid to the assignee.

Section 79 of the Regulation now provides that group insurance contracts on the life or health of debtors may, at the debtors' option, provide for an amount payable that is equal to the amount of their loan or, in the case of a contract extending variable credit, equal to the amount of the variable credit authorized by the creditor. In the latter case, the maximum amount payable to the creditor is limited to the net debt of the debtor, the balance being paid to the

designated beneficiary or, if applicable, to that person's succession. This last option is a new principle introduced by the Regulation.

SOME PROVISIONS OMITTED FROM THE REGULATION

All of the provisions of the Previous Regulation pertaining to the minimum excess amount of assets over liabilities that insurers are required to maintain have been omitted from the Regulation. Everything leads to believe that the Autorité des marchés financiers will henceforth rely on the provisions of the *Act respecting insurance* (Québec) and its guidelines in order to govern these aspects.

Moreover, all standards relating to the disclosure of conditions of individual insurance contracts and those relating to variable insurance contracts found in Sections 210 et seq. of the Previous Regulation were omitted from the Regulation. However, insurers will soon be subject to the Point of Sale Disclosure for Segregated Funds Guideline that will be adopted by the Autorité des marchés financiers. The guideline will, among other things, establish the specific expectations of the Autorité des marchés financiers with regard to the commercial practices of insurers who offer segregated funds to the public by means of individual variable insurance contracts. Moreover, the *Règlement modifiant le Règlement sur les renseignements à fournir au consommateur* (regulation amending the regulation respecting information to be provided to consumers), a draft of which was published in the September 4, 2009 issue of *Autorité des marchés financiers' Bulletin*, sets out new provisions pertaining to the information that representatives must give clients subscribing for segregated funds under individual variable insurance contracts.

CONCLUSION

Many other subjects dealt with in the Regulation were already contemplated by the Previous Regulation, but have been revised as to their terms and scope. More specifically, amendments applicable to insurance classes are designed to harmonize them with those of other provinces. The insurer investment rules that had not been revised for a number of years have been clarified and broadened. Moreover, the group insurance practices have been updated.

Insurers who do business in Québec should therefore examine the Regulation in light of their current activities in order to quickly comply with the new requirements that came into force on September 10, 2009.

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¹ R.S.Q., c. C-38.

² R.S.Q., c. A-32.

³ An insurer who, on September 9, 2009, holds a license to transact property insurance is deemed to hold a license to transact property insurance in addition to a license to transact fire insurance (s. 92 of the Regulation).

⁴ An insurer who, on September 9, 2009, holds a license to transact surety insurance is deemed to hold a license to transact surety and fidelity insurance (s. 91 of the Regulation).

⁵ R.S.Q., c. P-40.1.

⁶ Section 245 of the Act respecting insurance requires, however, that insurers hold, directly or indirectly through legal persons that they control, more than 50 per cent of the voting rights of the legal person or be able to elect a majority of its directors.

⁷ R.S.Q., c. D-9.2.

⁸ R.S.Q., c. S-29.01.

⁹ R.S.Q., c. I-3.

¹⁰ R.S.C. 1985, c. 1 (5th Supp.).

¹¹ R.S.Q., c. V-1.1.

¹² That said, insurers who were subject to s. 264 of the Previous Regulation on September 9, 2009 may continue to limit the amount of all insurance protection from which participants may benefit under the Previous Regulation until the master policy expires, and this by specifically applying the previous limits (s. 93 of the Regulation).

**• TAKING A RUN AT THE CONSTITUTIONAL DIVISION OF POWERS?
QUEBEC COURT APPLIES PROVINCIAL CONSUMER PROTECTION LAWS TO AWARD HUGE
DAMAGES IN CLASS ACTIONS AGAINST CANADIAN FINANCIAL INSTITUTIONS •**

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The Quebec Superior Court recently ordered ten Canadian financial institutions who issued credit cards to pay over \$200 million in general and punitive damages to Quebec card holders who used their cards to pay for goods or services in a foreign currency.¹ The Court's determinations in the three related class actions were premised on its finding that the card issuers had charged a fee or commission that was separate from amounts applied to card balances in respect of conversion rates.

The Court held that in failing to expressly disclose such a commission in their agreements with card holders, the federally chartered banks and credit union had breached certain provisions of Quebec's consumer protection laws. The financial institutions were ordered to pay the amounts collected in respect of such commissions as well as punitive damages. The decisions are particularly notable both in terms of the Court's application of provincial legislation to federally chartered banks and its characterization of conversion charges. The decisions are currently under appeal.

BACKGROUND

Three related class actions were brought against all major banks and credit card issuers operating in Quebec. The plaintiff classes were composed of card holders who used a credit card to enter into foreign currency transactions during a specific time period.

When a card holder makes a purchase in foreign currency, it appears on his or her monthly statement in the form of a global amount represented in Canadian dollars. The amount is calculated by multiplying the transaction amount by the exchange rate. The exchange rate encompasses two components:

- the daily conversion rate for the currency in question; and
- conversion fees that vary depending on the financial institution or the type of credit card.

The conversion rate is established by Visa, MasterCard or American Express based on an inter-bank market rate. The conversion fees are then added to the daily conversion rate. The conversion from the foreign merchant's currency to Canadian dollars is completed at the Visa, MasterCard or American Express network level rather than by the card issuing financial institution. The conversion fees, however, are applied by the financial institution. It is these conversion fees that were the subject of these class actions.

The plaintiff classes contended that the conversion fees billed by the banks were credit charges. If these fees constituted credit charges, Quebec's *Consumer Protection Act*, R.S.Q., c. P-40.1 (the "CPA"), would require that they be calculated and disclosed to the card holder in the form of an annual percentage. As certain of the defendant banks were alleged to have failed to expressly disclose the existence of conversion fees to their clients for a certain period of time, they may have been in contravention of the CPA, if it were to apply.

The CPA also requires that any "credit charges" be indicated in terms of dollars and cents on the card holder's statement and that the statement indicate that such charges relate to the period for which the card holder is being billed.

Further, if the conversion fees constituted credit charges within the meaning of the CPA, the defendant banks would not be in compliance with the provincial law given that conversion fees were imposed before a statement was sent to a card holder, without granting the 21-day grace period required by the CPA.

The defendant financial institutions contended that the conversion fees were not credit charges within the meaning of the CPA, but were rather "net capital". Under the CPA, credit charges cannot include net capital, or the amount of credit which is actually extended to the debtor. The financial institutions argued that the conversion fees were a component of the exchange rate that they billed when a transaction was completed in foreign funds. Further, according to the financial institutions, the conversion constituted a dis-

tinct service unrelated to the credit contract and was therefore not subject to *CPA* provisions that apply to credit charges.

Furthermore, the banks that did not expressly disclose the existence of conversion fees to their clients contended that the card holders were in fact aware of such conversion fees because such fees were simply part of the exchange rate and the card holder was only interested in knowing the global amount of the amount charged in respect of conversion and the global amount of the transaction.

The financial institutions also argued that the *CPA*, a provincial statute, is not applicable given that under Canada's *Constitution Act, 1867*, banking falls within the exclusive jurisdiction of Parliament rather than provincial legislatures. The financial institutions contended that the application of the *CPA* to their operations would impair credit card services and foreign exchange conversion services, vital and integral components of their banking activities. Accordingly, the doctrine of inter-jurisdictional immunity applied such that the provisions of the *CPA* relied upon by the plaintiff classes were inoperative or inapplicable.

The financial institutions also relied on the doctrine of federal paramountcy in this regard, which provides that when the operational effects of provincial legislation are incompatible with federal legislation, the federal legislation must prevail. The financial institutions contended that the relied upon provisions of the *CPA* conflict in operation with, and frustrate Parliament's purpose in, the federal *Bank Act*, S.C. 1991, c. 46 (the "Bank Act"), the *Financial Consumer Agency of Canada Act*, S.C. 2001, c. 9, and the *Cost of Borrowing (Banks) Regulations*.

THE COURT'S DECISION

The Court concluded that the conversion fees are in fact "credit fees" within the meaning of the *CPA*. This determination was driven in part by the fact that the currency conversion is completed at the Visa, MasterCard or American Express network level, while the conversion fees are imposed by the card issuers. This led the Court to determine that the conversion fees were imposed by the card issuers in relation to an agreement to provide credit and not in relation to a currency conversion service that they are providing. The Court also noted that as conversion fees are considered fees under the *Bank Act*, it is difficult to conceive that they would be anything else under the *CPA*. The Court concluded that the financial

institutions were charging card holders for currency conversion, a service that they were not providing. Notably, in reaching this determination, the Court found that credit cards do not extend credit in that most consumers pay their credit card balances in full and thus do not pay interest.

The Court also held that even if the fees in question were not credit fees, the *CPA* provides that no costs may be claimed from a consumer unless the amount is indicated in the relevant contract. The Court noted that the purpose of this requirement is to ensure that consumers are well-informed of the conditions of their contract. The Court also noted that the financial institutions were subject to similar disclosure obligations under the *Bank Act*. The Court thus concluded that unless a card issuer clearly discloses the exact amount charged for currency conversion services, the card issuer cannot claim such fees.

With regard to the card issuers' Constitutional arguments, the Court held that neither foreign currency exchange nor the extension of credit through credit cards are part of core banking activities and were thus not included in the activities over which Parliament is given exclusive jurisdiction under the *Constitution Act, 1867*. The Court thus concluded that banks are obligated to comply with any and all applicable provincial legislation in providing such services. The Court further held that there was no operational conflict between the *CPA* and the federal *Bank Act* or other applicable federal legislation, such that the doctrine of federal paramountcy did not apply and Parliament's efforts to regulate these areas were not frustrated by the application of the *CPA*.

The Court held that the class members were entitled to reimbursement of conversion fees paid and punitive damages totalling approximately \$200 million.

IMPLICATIONS

The decision is notable in terms of the Court's characterization of conversion fees charged in relation to foreign currency transactions. The court specifically rejected the card issuers' contention that the conversion fees are a component of the foreign exchange rate as they are part of the cost of converting foreign currency into Canadian currency. Instead, the Court limited the meaning of "exchange rate" to the difference in the value at which the relevant currencies are trading, rather than the rate at which the currencies are exchanged or converted by the credit card issuers.

Perhaps of more particular importance to financial institutions, however, was the Quebec Court's determination that provincial consumer protection legislation applied to and governed the operations of the federally regulated banks, at least within the realm of credit card operations and currency conversion. The decision suggests that financial institution credit card issuers, which generally operate on a national level, must comply not only with federal legislation and authorities that regulate banks in Canada, but also with any provincial statutes, such as consumer protection legislation, that touch upon their banking or credit operations. It suggests that credit card statements must be delivered in a form that addresses both federally and provincially mandated disclosure requirements.

The defendant financial institutions have appealed the decisions. Given the ambit and significance of the Court's decision, the Quebec Court of Appeal's review of the decisions will be eagerly anticipated by the banking and credit card industry.

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¹ *Marcotte v. Bank of Montreal et al.*, [2009] J.Q. No. 5771 (S.C.); *Adams v. AMEX Bank of Canada*, [2009] J.Q. No. 5769 (S.C.); and *Marcotte v. Federation Des Caisses Desjardins Du Quebec*, [2009] J.Q. No. 5770 (S.C.).

• DO SET-OFF RIGHTS CREATE SECURITY INTERESTS?

CANADA'S SUPREME COURT DECIDES THAT THEY DO IN THE CASE OF A CREDIT SUPPORT ARRANGEMENT INVOLVING CASH COLLATERAL •

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Set-off rights in the context of cash collateral arrangements providing credit support now stand a much greater chance of recharacterization as creating a security interest in the cash collateral as the result of a recent Supreme Court of Canada ruling in *Caisse populaire Desjardins de l'Est de Drummond v. Canada*, [2009] S.C.J. No. 29, 2009 SCC 29. The issue was whether an agreement between a lender and borrower with respect to set-off against a term deposit gave rise to a "security interest" within the meaning of s. 224(1.3) of the federal *Income Tax Act*, R.S.C. 1985, c. 1 (5th Supp.) ("*ITA*").

BACKGROUND

Concurrently with the extension of a business line of credit, Caisse populaire Desjardins de l'Est de Drummond (the "Caisse") and its customer, a company named Camvrac, entered into a "term savings agreement" ("TSA") requiring Camvrac to deposit

\$200,000 for a five-year term. The deposited funds were not transferable, could not be charged or given as security to any person other than the Caisse, and there was no right of withdrawal or redemption prior to the maturity date. The TSA provided explicitly for set-off ("compensation" under Quebec law) between the funds owed by Camvrac under the line of credit and the funds owed by the Desjardins to Camvrac under the TSA — the set-off being effected in the event that the company defaulted on the line of credit. The two parties also entered into an unadvisedly named "Security Given Through Savings" agreement, under which it was agreed that Camvrac would maintain the deposit to "secure the repayment of" a line of credit, among other things. Camvrac defaulted promptly after the arrangements were put in place, but the Caisse did not take any steps until two or three months later, two weeks after Camvrac had made an assignment in bankruptcy. At this point,

the Caisse made a note on its copy of the TSA: “To be closed on 21/2/2001 to realize on security” (another unfortunate choice of language). In the aftermath of Camvrac’s assignment in bankruptcy, the Government of Canada (the Crown) demanded that the Caisse pay Camvrac’s unremitted employment insurance (“EI”) premiums and outstanding at-source tax withholdings out of the term deposit funds that it had set off against Camvrac’s credit line debt. The Crown argued that the terms of the TSA created a “security interest” within the meaning of s. 224(1.3) of the *ITA*, and that the funds that were set off against were subject to the deemed trust in favour of the Crown. Like the courts below, the majority on the Supreme Court agreed.

THE LAW

Both the *ITA* and the *Employment Insurance Act*, S.C. 1996, c. 23 (“*EIA*”) create deemed trusts in favour of the Crown over property of an employer that has deducted income tax and EI premiums at source. The deemed trust also applies to property of the employer held by any secured creditor of the employer that, but for its security interest, would be the employer’s property. “Security interest” is defined as:

any **interest in property** that secures payment or performance of an obligation and includes an interest created by or arising out of a debenture, mortgage, hypothec, lien, pledge, charge, deemed or actual trust, assignment or encumbrance of any kind whatever, however, or whenever arising, created, deemed to arise or otherwise provided for.

[Emphasis added]

The point of dispute between the majority and minority judgments turned on whether the set-off arrangements created an interest in property of the employer Camvrac. The majority held that in the circumstances of the case they did, while the minority drew the opposite conclusion.

Traditionally it has been held that a right of set-off does not constitute a security interest because it is not an arrangement that gives a creditor a property right in the asset against which set-off is effected. Set-off is a right (contractual, legal or equitable) that allows a party owed an amount to use that right to satisfy its own obligation. For example, a lender owed money by a borrower could employ that asset (the receivable) to satisfy its own obligation to the borrower pursuant to a deposit agreement. Under the deposit agreement,

the lender has an obligation to return the amount on deposit to the borrower. The set-off does not depend on the lender having a property interest in the deposit. The party setting off, the lender, has an obligation and is entitled to satisfy that obligation by setting off an obligation owed to it by the other party, the borrower. Set-off has nothing to do with realizing on a property interest. Even if there is a security interest in one’s own obligation (*i.e.*, the lender held a security interest in the funds it owed to the borrower), as there was in this case, that set-off right can exist quite independently of that interest (and in a properly drafted agreement, that would be clear).

THE MAJORITY’S REASONS

In this case, however, the majority — embracing a contemporary “functional” understanding of a security interest — held that the TSA did create a security interest in the deposit and that the right of set-off was the means to enforce that security interest. Restrictions on the company’s ability to deal with its term deposit were equated with a security interest.

In support of the majority’s conclusion, Mr. Justice Rothstein stated:

It is the encumbrances placed on the debtor’s claim against the creditor that ensure that the creditor will remain liable to the debtor and, in this way, ensure an effective compensation remedy.

In the view of the majority, these encumbrances placed on the deposit amounted to the acquisition by the Caisse of a property interest in Camvrac’s deposit, primarily because they ensured that the Caisse would be continuously liable to Camvrac. Justice Rothstein noted that, had Camvrac been in a position to shift its funds in and out of the term account, there would have been no security interest.

The majority stressed that they were not saying that a contractual set-off right is *per se* a species of security interest. Rather, they held that, in light of the fact that the term deposit was structured so as to be available for set-off as long as the credit line continued, the terms of this particular agreement justified the recharacterization of the transaction as a whole as the grant of a security interest.

THE DISSENT

In dissenting reasons, Madam Justice Deschamps strongly disagreed with the majority view. Taking a position reflecting that of many practitioners in the

banking industry, and invoking a rather impressive range of academic commentary, she concluded that security interests can only be derived from “real rights” in property and never from the attenuated type of contractual right to which the majority referred. She concluded that a security interest is created only where a real right is acquired, a right in the property itself, as opposed to the right to compel a person to perform an obligation, which is the essence of a personal right. Not all interests in property are security interests. In this case, she noted, the Caisse had no right to realize on its interest to secure performance of the obligation owed to it. The potential to appropriate the underlying property, she maintained, is one of the distinguishing features of a security interest. The “encumbrances” that the majority relied on did not give an appropriation right — “neither the term for repayment, nor the obligation to maintain, nor the right to withhold, nor the limit on the right to transfer, hypothecate or negotiate would enable the Caisse to realize on the deposit or appropriate the deposit amount to ensure performance of the secured obligation”. A bank deposit creates a debtor-creditor relationship in which the bank is indebted to the depositor for the sum on deposit. The clause establishing the term merely stipulated the time for repayment of the indebtedness. The right to withhold and deduct is a right of the Caisse not to perform an obligation to repay its indebtedness to the depositor as long as a debt is owing by the depositor to the Caisse. The obligation to maintain is an undertaking to perform an obligation. The restriction on transfer and hypothecation is an obligation not to do something. Justice Deschamps concluded:

I cannot see how these rights, whether considered in isolation or as a whole, might constitute a security interest as that term is defined in s. 224(1.3) *ITA*. None of them provides a basis for using the property to ensure performance of the obligation, and none of them constitutes an interest in property that secures performance of an obligation.

IMPLICATIONS OF THE RULING

As a result of the Court’s decision that a security interest existed, the Caisse became liable to the Crown for the unremitted EI premiums and at-source income tax deductions, because those funds were impressed with a deemed trust in favour of the Crown over Camvrac’s property in which the Caisse merely had an unperfected and subordinated security interest.

Normally, priority with respect to security interests perfected by filing would be determined by order of registration. However, given the contractual right to set-off, the recognition of the paramountcy of defences in s. 40 of the Ontario *Personal Property Security Act*, R.S.O. 1990, c. P.10 (“*PPSA*”) (and its equivalent in other common law provinces) should ensure priority over other secured parties that have filed under the *PPSA*. Section 40(1.1) of the Ontario *PPSA* provides that an account debtor may set up by way of defence against the assignee all defences available to the account debtor against the assignor arising out of the terms of the contract or a related contract (unless it has contractually waived defences). By way of example, where a lender takes a deposit of cash collateral from a borrower, the lender is the account debtor of the borrower, the borrower is the assignor and a third party is the assignee, *i.e.* another secured party who has a security interest in all the borrower’s assets. The “account” in this case is the amount owing by the lender to the borrower for the cash collateral it has received from the borrower and the defence is the right under the agreement between them to set-off against the amounts owing to the lender any of the amounts on deposit. The lender, following the exercise of its set-off right, would only be obligated to return to the borrower the net amount, if any, following such application. In this example, perfection should not be relevant to priority as against other consensual security interests or other assignees. It is somewhat unclear, however, how s. 40 would relate to the rights of a trustee in bankruptcy as representative of the unsecured creditors or other non-consensual lien claimants, so it may be advisable to file a financing statement in any event to preclude any argument that there is an unperfected security interest.

A central problem with the majority’s analysis is that it fails to differentiate between an agreement that provides credit support or assurance and a security interest. While all security interests provide credit support, the converse is not true: not all credit support arrangements are security interests. For example, a guarantee provides credit support but does not grant an interest in property to secure payment or performance of an obligation. It is in the nature of a personal right — a right to compel a person to perform an obligation. The intention to provide credit support is quite distinct from the intention to confer a security interest in one’s property. Such distinctions may have been lost on the majority partly be-

cause of the drafting of the agreement, which unwisely used “security language”. The majority did agree that a property interest must be created in the debtor’s property, but its conclusion that there was such a property interest and that the right of set-off was the means to enforce that interest is dubious. One can only hope that it will be restricted in any subsequent application to situations where the intention to create a security interest is present on the face of the document and where the set-off rights are not part and parcel of the asset itself (*i.e.* the terms of the deposit itself do not provide for the set-off).

However that may be, the ruling is now a part of Canadian law and may require adjustments to lending practices. In particular, it is important to note that while the case dealt with the deemed trust provisions of the *ITA* and the *EIA*, its implications could extend further into the realm of personal property security law. Moreover, it potentially affects not only cash collateral arrangements but title transfer arrangements, escrow arrangements, pre-payment arrangements and consignments. The de-

cision clearly increases recharacterization risk in all of these situations.

For parties who have required credit support, a review of the documentation should be considered, in addition to the possibility of making a cautionary *PPSA* filing. Care will need to be taken in ensuring that any cash collateral arrangements entered into are clearly drafted to avoid being recharacterized by avoiding language implying an intention to give a “security interest” in relevant documentation and even by specifically disclaiming the intention to create such an interest, much as occurs already with respect to title transfer arrangements in credit support agreements.

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• PROPOSED VOLUNTARY CODE OF CONDUCT WILL MATERIALLY AFFECT CANADA’S PAYMENTS SYSTEMS IF ADOPTED •

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On November 19, 2009, the Honourable Jim Flaherty, Minister of Finance, announced the latest action the federal government will take to regulate Canada's credit and debit industry and released for public consultation a draft voluntary "Code of Conduct for the Credit and Debit Card Industry in Canada" (the "Code"). If adopted by payment card networks, the Code's "Recommended Policy Elements" will need to be incorporated in payment card networks' governing rules, regulations and contracts and will materially affect the business practices and costs of payment card networks and their participants, including card issuers and merchant acquirers and processors.

THE PURPOSE OF THE CODE

The purpose of the Code is stated to be to demonstrate the commitment of the credit and debit card industry to three main goals:

1. ensuring that merchants are fully aware of the costs associated with accepting credit and debit card payments from customers so that merchants can reasonably forecast their monthly costs associated with accepting such payments;
2. providing merchants with increased pricing flexibility to encourage their customers to choose the lowest-cost payment option; and
3. allowing merchants to freely choose which form of payment they will accept.

THE EFFECT OF THE CODE'S POLICY ELEMENTS

Nine separate "Recommended Policy Elements" form the backbone of the Code and will affect payment card networks and their participants in a variety of ways:

PAYMENT CARD NETWORKS:

- together with the merchant acquirers, payment card networks must ensure that a "sufficient" level of detail is provided in the merchant acquirer's contracts and monthly statements and that the contracts and statements are easy to understand;
- must post all applicable interchange rates and fees and upcoming changes to these rates and fees (once provided to acquirers) on their websites;
- must provide acquirers with sufficient notices of changes to their interchange rates and structure, as well as any other fees; and
- will not require merchants to "honour all cards" so that they must accept both credit and debit payments from that network.

ACQUIRERS:

- must ensure that a "sufficient" level of detail is provided in the merchant acquirer's contracts and monthly statements and that the contracts and statements are easy to understand;
- must provide merchants with at least 90 days notice of changes to merchant fees;
- must include in the merchant contract the right of a merchant to terminate a contract without penalty within 90 days after notice of a fee change; and
- must permit priority routing of debit payments for co-badged debit cards depending on the merchant's choice of debit payment option.

ISSUERS:

- must ensure that co-badged debit cards clearly indicate the available payment options without giving preferential branding to one network over another;
- may not issue credit payment options and debit payment options on the same payment card; and

- may only issue premium cards to a "specific clientele who meet specific spending and income thresholds".

MERCHANTS:

- will have the right to terminate their contracts with acquirers without penalty within the 90 days following notice of a fee change;
- will not be required to "honour all cards" from a payment card network and may choose to accept only debit or credit payments from a network without having to accept both;
- will be permitted to provide differential discounts for various payment methods and brands; and
- will be able to choose which debit payment option they will accept when presented with co-badged debit cards.

CALL AND RESPONSE: FEDS CREATE A CODE TO CALL THEIR OWN

The Code appears to be a direct response to the recent Standing Senate Committee on Banking and Trade and Commerce's report entitled "Transparency, Balance and Choice; Canada's Credit Card and Debit Card Systems", which was tabled on June 30, 2009. The report, which was the subject of our recent article entitled "Raising the Stakes: Senate Committee Reports on Canada's Debit and Credit Card Systems", called on the federal government to take action by listing six key recommendations.

However, the federal government did not simply codify the Senate's proposals. While the Senate called on the federal government to establish a code of conduct for payment systems participants, the subject of that recommended code was in respect of setting fees and rates. The federal government continues to leave fees unregulated, but did incorporate some of the Senate's other recommendations into the Code. For example, the Code permits merchants to offer discounts to customers for using certain payment methods and clearly prohibits "honour all cards" rules. The Code does not, however, contemplate surcharges or informing the consumers about lower-cost payment methods. Instead of prohibiting point of sale priority routing where cardholders select their preferred payment option, the Code enables merchants to choose their pre-

ferred payment option when accepting payment. At this time, it seems unlikely that any enforcement mechanisms will be incorporated into this voluntary Code and it is unclear how the participants will be monitored to ensure compliance other than by the payment networks.

The Code as drafted overwhelmingly imposes obligations on payment card networks, issuers, acquirers and processors. Although merchants are clearly the intended beneficiaries, the consumer is curiously left out of its scope. Consumers are only referenced in the Code in the constraint placed on issuers to only issue premium cards to a "specific clientele". No further guidance is provided on who will get to decide the characteristics that such specific clientele will need to embody let alone the characteristics themselves. For merchants, there will also be some unintended consequences. For example, the priority routing that merchants can require will entail costly system changes and thereby increase acceptance fees for a given payment option.

Stakeholders have been invited to comment on the Code during the 60-day period following the November 19, 2009 release. After the Code is in its final form, there will be an implementation period to ease the transition for those payment networks that adopt it.

THE NEXT PIECE: COMPETITION BUREAU TO REPORT IN NEAR FUTURE

The House of Commons Standing Committee on Industry, Science and Technology continues to hold

hearings on Credit Card Interchange Fees and the Debit Payment System in Canada. According to evidence presented at a recent hearing the Competition Bureau is poised to make two eagerly anticipated public announcements: (1) their decision on whether they will oppose an application by Interac to the Competition Tribunal to change its 1996 Consent Order; and (2) what their next steps will be with respect to their inquiry into whether Visa and MasterCard have acted in an anti-competitive manner.

The Competition Bureau was clear that it was for the Competition Tribunal to decide whether the 1996 Interac Consent Order would be amended. Nevertheless, it will be interesting to discover whether the Competition Bureau will oppose Interac's request for an amendment.

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The *National Banking Law Review* is published six times per year by LexisNexis Canada Inc.
This issue is cited as 29 Nat. B.L. Rev.

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Price: \$365 for six issues and annual index. Binder available at \$20 upon request.
\$435 for Print & PDF

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ISBN 0-409-91076-7
ISBN 0-433-44389-8 (Print & PDF)
ISBN 0-433-44684-6 (PDF)

ISSN 0822-1081

The Journal is indexed in the *Index of Canadian Periodical Literature*
and in the *Index to Canadian Legal Literature*.
Publications Mail Registration No. 180858