NOTES AND CASE COMMENTS

LEASE-OPTION CONTRACTS UNDER THE CONDITIONAL SALES ACT

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In *Ramsey* v. *Pioneer Machinery Co. Ltd.*[1] the Alberta Court of Appeal considered the applicability of the Conditional Sales Act[2] to leases of personal property containing options to purchase.

Two questions were considered. First, are such lease-option agreements required to be registered to protect the lessor's proprietary interest against subsequent purchasers, mortgagees, etc., from the lessee? Second, to what extent, if any, does the "seize or sue" restriction found in s.19 of the Conditional Sales Act (now found in s.49 of the Law of Property Act[3]) apply to such agreements?

The facts are straight forward enough. The respondent, Pioneer Machinery Company Ltd. had leased equipment to a lessee; concurrently an option agreement on the same machinery was drawn up in a different document. While two documents were executed it is a finding of fact that they were but part of one transaction. The agreement provided for rentals over a three year period which would pay all but $9,000 of the $375,000 value of the machinery, together with interest at 15%. The option to purchase was for $9,000. Ultimately the lessee defaulted, never exercised the option to purchase and, in fact, went bankrupt. The equipment was sold and the lessor claimed priority to the proceeds of disposition as against the trustee in bankruptcy and a receiver under a mortgage.

The main argument put forward by the trustee in bankruptcy and the receiver was that since the lessor had not registered under the Conditional Sales Act it had lost its priority. The relevant provisions are found in s. 2(1) and s. 2(3) which read:

> 2(1) When on sale or bailment of goods of the value of $15.00 or over it is agreed, provided or conditioned that the right of property or the right of possession in whole or in part remains in the seller or bailor notwithstanding that the actual possession of the goods passes to the buyer or bailee, the seller or bailor is not permitted to set up any such right of property or right of possession
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> (a) as against a purchaser or mortagee of or from the buyer or bailee of such goods in good faith for valuable consideration, or
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> (b) as against judgments, executions or attachments against the buyer or bailee,
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> unless the sale or bailment with such agreement, proviso or condition is in writing signed by the buyer or bailee or the agent of the buyer or bailee (hereinafter referred to as a "conditional sale agreement") and registered as hereinafter provided.
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> (3) Nothing in this section applies to a bailment where it is not intended that the property in the goods shall eventually pass to the bailee.
>
> (a) on payment of the purchase money in whole or in part, or
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> (b) on the performance of some condition by the bailee.

The trial judge held that the lease-option agreement fell within subsection (3) because it was found that ". . . it was not intended that the lessee would purchase as he had the option of terminating the lease, continuing

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1. (1981) 15 Alta. L.R. (2d) 140 (C.A.).
2. R.S.A. 1980, c. C-21.
3. R.S.A. 1980, c. L-8.

it, or purchasing, and . . . purchase was not something which could be presumed to take place".[4] In short, the option exercise price was *not* nominal.

Prior to the Court of Appeal decision in *Ramsey Machinery* there was some judicial support for the proposition that whether lease-option agreements were required to be registered had to be decided on a case-by-case basis. This was based on the wording of the proviso in s. 2(3) of the Conditional Sales Act:

> Nothing in this section applies to a bailment where *it is not intended* that the property in the goods shall eventually pass to the bailee on payment of the purchase price . . . . [emphasis added]

Intention is, of course, present in some cases while not in others. Thus in *Doug Dunlop Leasing Ltd.* v. *Seward*,[5] Kidd D.C.J., as he then was, had to decide whether a lease-option agreement fell under what was then s.19 of the Conditional Sales Act, the "seize or sue" remedy limiting provision. Admittedly, s.19 does not raise precisely the same issues as the basic registration requirements under s.2. Nevertheless, the wording in s.19(1)(c) as to jurisdiction is similar. Section 19(1)(c) reads:

> Subject to subsections (6) to (8), this section applies only to a sale or agreement for the sale of goods of any of the following kinds namely,
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> (c) a sale made pursuant to a contract of bailment under which it is intended that the property in the goods will pass to the bailee on the payment of the purchase price in whole or in part or on the performance of a condition.

In *Doug Dunlop* it was found, after an inquiry into the facts, that the necessary intention was present. However, in *Crosstown U-Drive and Leasing* v. *Maclean*,[6] a different conclusion was reached about the applicability of s.19 and *Doug Dunlop* was distinguished on the facts:[7]

> The *Doug Dunlop Leasing* case deals with the situation where, upon termination of a lease and upon payment of a nominal sum by the lessee to lessor, title to the vehicle in question would pass to the lessee. Kidd D.C.J. held that there was a clear intention of sale and that the agreement in that case was, in fact, a conditional sales agreement.
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> In this case I can find no initial intention that the property to the goods would pass to the lessee as was found . . . in the *Doug Dunlop Leasing* case.
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> The agreement before me provides that it is one of lease only and that the lessee shall not have or acquire any right, title or interest in or to the vehicle, except the right to use or operate it as provided in the agreement. In my opinion, an option to purchase the vehicle at the end of the lease term for $2,720 does not, without more, create the necessary intention to bring the transaction within s.19(1)(c) of the Conditional Sales Act.

Thus, it would appear that prior to *Pioneer Machinery* a decision whether lease-options were legally required to be registered necessitated an inquiry into the intention of the parties at the time of the making of the agreement. This was most unsatisfactory and any astute lessor or his legal advisor would register regardless.

Now it appears that the Alberta Court of Appeal has clarified matters considerably. Stevenson J.A., delivering the Court's judgment, first reviewed at length the legislative history of s.3 and its predecessor provisions in Territorial Ordinances. The Court concluded:[8]

> On balance it is my interpretation that the proviso should be read as excluding the pure lessor/lessee but not the lessee who has it within his power to acquire ownership.

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4. *Supra* n. 1 at 146.
5. (1977) 2 Alta. L.R. (2d) 176 (D.C.).
6. (1979) 10 Alta. L.R. (2d) 171 (D.C.).
7. *Id.* at 176-177.
8. *Supra* n. 1 at 147.

Therefore, notwithstanding that it was not intended that the option be exercised, the Court held that the transaction fell within s.3 and was thus required to be registered.

From the perspective of public policy the decision on this point is eminently sensible. First, it clarifies the law considerably, putting lessors on notice precisely as to when they must register. Second, such agreements probably ought to be required to be registered. Personal property under such agreements tends to be in possession of the lessees for long periods of time in circumstances such that it appears to the outside observer that the lessee-optionee is actually the owner. To protect prospective purchasers from or mortgagees of the lessee a requirement of registration is necessary. Of course, much the same can be said of long term leases containing no option to purchase. However, there is no way that s. 2 can be interpreted to require registration of such "pure" leases. Note that under proposed uniform Personal Property Security legislation all leases, with or without options to purchase, for a term of more than one year must be registered.[9]

A perhaps unintended consequence of the judgment is the possibility that the decision in *Pioneer Machinery* could imply that the technique of inventory financing known as supplying goods on "sale or return" must also be registered. Goods supplied on "sale or return" are normally bailed by a supplier to a retailer on the understanding that if the retailer cannot find a buyer he will be entitled to return the goods to the supplier. Technically, title remains in the supplier until a retail buyer is found or the retailer decides to buy the goods notwithstanding the absence of a customer. The proper legal characterization of such a "sale or return" arrangement is that of a bailment with an option in the bailee to purchase. The bailee may exercise the option expressly or impliedly. Implied exercise includes acts inconsistent with the seller's ownership, e.g., reselling the goods. At that time, there would be a sale from the supplier to the retailer and a resale from the retailer to his customer.[10]

Now, s. 2 of the Conditional Sales Act requires registration of bailments, excluding only those where "it is not intended that the property in the goods shall eventually pass to the bailee . . . ". Given that the Court of Appeal has stated that leases with options to purchase are not those types of bailments falling within the proviso, does it not logically

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9. *See e.g.*, the definition of "security interest" in proposed s.1(s) of Bill 98, (1980), Second Session, 19th Legislature, 29 Elizabeth II, The Personal Property Security Act.

10. Section 21(5) of the Sale of Goods Act, R.S.A. 1980, c. S-2 provides a presumption as to when property passes to the bailee in a "sale or return" transaction. The act states:

> When goods are delivered to the buyer on approval or "on sale or return" or other similar terms, the property in them passes to the buyer
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> (a) when he signifies his approval or acceptance to the seller or does any other act adopting the transaction, or
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> (b) if he does not signify his approval or acceptance to the seller but retains the goods without giving notice of rejection then if a time has been fixed for the return of the goods, on the expiration of that time, and, if no time has been fixed, on the expiration of a reasonable time, and what is a reasonable time is a question of fact.

It would seem that when a bailee of goods on "sale or return" sells the goods to a retail buyer, this would be an "act adopting the transaction" such that property would then pass from bailor to the bailee and then almost simultaneously from the bailee to his buyer. This sequence of events would turn the bailment with the option to purchase into a sale and resale.

follow that other non-lease bailments with options to purchase fall without the s.2(3) proviso? The only conceptual difference between lease-options and "sale or return" relationships is that in the former case the bailment arises by way of lease whereas the bailment in the latter is usually gratuitous. They are both, however, bailments with options to purchase and the Act refers to bailments, not to leases.

There are valid reasons well founded in public policy why "sale or return" bailments should be required to be registered. As the goods in a "sale or return" bailment are on the bailee's commercial premises often commingled with goods actually owned by the bailee, this type of bailment is apt to deceive other creditors or security takers of the bailee. This is precisely the evil which the requirement of registration under the various personal property security statutes was supposed to remedy.

If "sale or return" bailments do in fact fall within the registration requirements of the Conditional Sales Act then the distinction between such bailments and goods given under a consignment or agency relationship becomes quite important.[11] In a consignment or agency relationship the retailer, when he sells the goods, does so on behalf of the supplier. There is no sale and resale; rather, there is one sale from the supplier to the customer of the retailer through the agency of the retailer. When the goods are in the possession of the agent there is a bailment. However, unlike the case of a "sale or return" bailment there is normally no option to purchase. Hence the proviso in s.2(3) ought to apply as there is no intention that property pass to the bailee.

The Court's analysis of the applicability of s.19 was more complex. Section 19, now s.49 of the Law of Property Act, essentially provides that if the conditional seller seizes the goods comprising the subject matter of the conditional sales contract, he can no longer sue for the purchase price but is restricted in his remedy to seizure of those goods. However, the application of the section to *bona fide* lease-option agreements has always been clouded with uncertainty. That is, if a lessor seizes goods under a lease-option agreement because of default in payment of a rental instalment does the section operate to extinguish future unpaid rentals much as in an actual conditional sale agreement seizure of the goods extinguishes rights to unpaid instalments of the purchase price? Or, does the section operate so as to extinguish upon seizure only what can legally and technically be characterized as the purchase price, namely, the price payable to the vendor on the exercise of the option? The Court held that the section as applied to lease-option agreements only comes into effect if and when the option is exercised:[12]

> I am of the view that the section clearly does not apply and cannot apply before the exercise of that option. Until the option is exercised the lessor is not pursuing his "right to recover the purchase price". If he chooses to recover the chattel he is exercising his right of possession on default, which is a right independent of any money claim. I have no hesitation in saying that s.19(2) is not applicable unless the lessor is seeking to recover the purchase money and he cannot seek to recover the purchase money until the option is exercised.

The practical ramifications of this are that a seizing lessor can still recover unpaid rental instalments. This would seem to be true even if the option had been exercised; by the Court's reasoning and as the section

11. For an illustration of a case raising this distinction *see Weiner* v. *Harris* [1910] 1 K.B. 285 (C.A.).

12. *Supra* n. 1 at 148.

literally reads all that is extinguished is the purchase price and that, in a lease-option agreement, is the option exercise price, not prior rental instalments.

It should be noted that the Court's decision on this point runs counter to two lower Court decisions. In *Doug Dunlop Leasing Ltd.* v. *Seward*, it was held that s.19 applied and the plaintiff " . . . [was] not entitled to arrears of rental . . . ".[13] To the same effect was *International Harvester Credit Corp. of Canada, Ltd.* v. *Dolphin*.[14] However, the Court in *Pioneer Machinery* distinguished the above two cases on the grounds that they concerned agreements which were leases in form but "in substance" conditional sale contracts. Indeed, the court left open the possibility that contracts which are lease-options in form only, might in the future be treated as conditional sale contracts for the purposes of s. 49:[15]

> It may be that a "lessor" who is found to be, in substance, a "conditional sales vendor" should be treated as a vendor claiming his purchase price within the section . . . .

One would hope that this would be so. Otherwise, framing a conditional sale contract as a lease agreement with a nominal option to purchase would be an effective mechanism for evading the protection to the conditional buyer afforded by s.49.

In general, *Ramsey Machinery* does much to clarify the law. Any future litigation in this area will likely be confined to a determination of whether given lease-options are "in substance" conditional sale contracts for the purpose of ascertaining what encompasses the purchase price extinguishable under s. 49 of the Law of Property Act.

13. *Supra* n. 5 at 180.
14. (1978) 7 Alta. L.R. (2d) 123 (S.C.T.D.).
15. *Supra* n. 1 at 148.