GENERAL PRIORITY RULES

I. INTRODUCTION

What happens when two secured parties have competing security interests in the same collateral? If one is unperfected and the other perfected, OPPSA, s 20(1)(a)(i) applies to give the perfected secured party priority. What if both are perfected (or both are unperfected)? The answer largely turns on the OPPSA's general priority rules in s 30. These are a critical part of the OPPSA, both to resolve priority disputes when they occur between secured parties and to give secured parties a clear path to avoiding unexpected disputes. Overall, they promote informed lending; if a secured party cannot determine its priority, it cannot assess its risk in extending credit, and if it cannot assess its risk in extending credit, it may be unwilling to extend credit in the first place or may impose higher costs on the debtor for that credit.

Section 30 opens with the words "If no other provision of this Act is applicable." In other words, the s 30 rules are the residual rules that apply if there is no other specific priority rule applicable to resolve the priority dispute. These other priority rules are found in various other provisions of the OPPSA and are examined in more detail later in this book.

The pre-PPSA priority rules between competing consensual security interests were a complicated amalgam of common law, equitable, and statutory rules. However rational in their historical and doctrinal origins, these rules are difficult to justify in the context of modern financing arrangements. More particularly, the common law placed primary emphasis on the locus of legal title and therefore gave priority to the person who held title unless that person was estopped from denying the authority of the person in possession of the collateral to deal with it or unless they had failed to comply with an applicable registration requirement. The priority of equitable security interests was generally governed by the order of their creation, but this rule was qualified in at least three respects. First, an equitable security interest could be defeated by a purchaser for value and without notice of the legal interest (*Joseph v Lyons*[1]). Second, floating charges were governed by their own priority rules that turned as much on the distinctive character ascribed to the security device by the courts as on its equitable origins. Third, under the rule in *Dearle v Hall*,[2] where there were successive assignments of the same chose in action (and originally such assignments were recognized only in equity), priority went to the assignor who first gave notice of their assignment to the debtor.

The PPSAs replace this disparate set of rules with a much better integrated and functionally oriented regime of rules.

II. SECTION 30 AND THE GENERAL PRIORITY RULES

The general priority rules are set out in s 30 of the OPPSA and are the starting point for an understanding of the Act's priority structure. The rules in s 30(1) may be paraphrased as follows:

1. *Rule of first to register.* If the competing security interests have all been perfected by registration, then the order of registration determines the order of priority (s 30(1), rule 1). The time of attachment or perfection of the security interests is not relevant.
2. *Rule of first to register or to perfect by other means.* If one security interest is perfected by registration and the other security interest is perfected by other means, then (a) if registration occurs before the perfection of the other security interest, the security interest perfected by registration will take priority (s 30(1), rule 2(i)), and (b) if the perfection of the security interest perfected by other means precedes the registration, the security interest perfected by other means will take priority (s 30(1), rule 2(ii)). Under this rule, the relevant date for the security interest perfected by other means is the date of perfection, not the date of the perfecting event, so, for example, if the secured party takes possession on Day 1 but attachment does not occur until Day 2, Day 2 is the relevant date, not Day 1, since perfection only occurs on Day 2.
3. *Rule of first to perfect.* If both security interests are perfected otherwise than by registration, then the security interest that is perfected first takes priority (s 30(1), rule 3).
4. *Rule of first to attach.* If all of the competing security interests are unperfected, they rank according to the order of attachment (s 30(1), rule 4).

The common feature of each of these rules is first in time: Rule 1 looks to first in time to register, Rule 2 looks to first in time between registration and perfection by other means, Rule 3 looks to first to perfect, and Rule 4 looks to first to attach. As can be seen, the OPPSA (as well as the other PPSAs and Revised Article 9) generally rewards the party who is first in time on the basis that, so long as a party contemplating a grant of credit can, in some fashion, ascertain if there is already a creditor with security, the creditor who is subsequent in time should accept the risk of lower priority. For a more detailed discussion of the policy behind the first in time approach, see Thomas H Jackson & Anthony T Kronman, "Secured Financing and Priorities Among Creditors."[3]

1 (1884-85), 15 QBD 280 (CA).
2 (1823), 3 Russ 1, [1824-34] All ER Rep 28 (Rolls Ct).
3 (1979), 88 Yale LJ 1143.

Section 30(1), rule 3.1, which was enacted in 2019, allows priority rules to be created by regulation for prescribed classes of collateral. No classes of collateral have been prescribed.

Section 30.1 (which was added to the statute in 2006 at the same time that the STA was enacted) contains special priority rules for security interests in investment property. The key rules are as follows:

1. *Control trumps non-control*. A security interest perfected by control has priority over another security interest perfected otherwise than by control.
2. *Two security interests perfected by control*. If two or more security interests are perfected by control, they rank in priority by first in time to obtain control.
3. *Securities intermediary priority*. Despite the above rules, in the indirect holding system, a securities intermediary with a security interest in a security entitlement or a securities account maintained by the securities intermediary has priority over other secured parties, unless the intermediary otherwise agrees.

For a more detailed summary, see the Cameron extract in Chapter 4, Section IV. Note that the control rules for investment property are different from the control rules for electronic chattel paper, as discussed in more detail in Chapter 9, Section IV.F.

In summary, the general rules for contests between two secured parties for collateral, other than investment property, are as follows (again, in each case subject to various exceptions):

1. *Perfected vs Perfected (both by registration)*. See s 30(1), rule 1.
2. *Perfected vs Perfected (one by registration and one not).* See s 30(1), rule 2.
3. *Perfected vs Perfected (both not by registration).* See s 30(1), rule 3.
4. *Unperfected vs Unperfected.* See s 30(1), rule 4.
5. *Unperfected vs Perfected*. See s 20(1)(a)(i).

III. IS KNOWLEDGE RELEVANT?

Consider the following:

Example 1

SP1 lends $100 to Debtor on the security of Debtor's grand piano. SP1 fails to perfect its security interest. Debtor then borrows $100 from SP2, who also takes a security interest in the piano, even though Debtor tells SP2 about the security interest it already granted to SP1. SP2 perfects by registration. The next day SP1 perfects by registration. In a contest between SP1 and SP2, who wins?

SP2 is first in time to register, and so, if s 30(1), rule 1 applies, it wins. But SP1 may argue that, since SP2 knew about the prior security interest, it should not be permitted to assert priority. Should SP2's knowledge matter? Is it fair that SP2 can defeat a prior security interest that it knew of? The issue is addressed in the following extract.

Robert Simpson Co Ltd v Shadlock

1981 CanLII 1789, 31 OR (2d) 612 (H Ct J)[4]

GRAY J: The issue is whether priority as between competing security interests in the same collateral security is determined under the Personal Property Security Act,

4 The case was decided under the 1967 Ontario PPSA, but the reasoning applies equally to the current Act.

R.S.O. 1970, c. 344, by whoever perfects or registers first or whether actual notice may defeat a claim to priority based on prior registration or prior perfection.

It was agreed that if priority is determined only by registration or perfection, the plaintiff has no claim in law but if the doctrine of actual notice prevails, the defendant cannot succeed on the application to strike out the plaintiff's statement of claim. Between February 18th, 1976, and June 24th, 1976, pursuant to 11 conditional sale contracts, the plaintiff sold to the debtor certain chattels for installation at a motel property. On or about June 4th, 1976, an employee of the plaintiff put the defendants on notice of the plaintiff's security interest.

On June 14th, 1976, the debtor mortgaged the motel to the defendants and also on the same date by chattel mortgage mortgaged the chattels and equipment in the motel, including the plaintiff's chattels, to the defendants. The defendants' chattel mortgage was registered under The Personal Property Security Act on June 17, 1976, but the plaintiff did not register its conditional sales contracts under that Act until February 7, 1978.

The relevant sections of The Personal Property Security Act are [ss 1(k), 1(y), 12(1), 21, 22(1)(a), 25(1), 25(2), 35(1), and 36(3)].

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The submission made by counsel for the defendants in summary form was that the only section of the Personal Property Security Act which applied was s. 35 [current OPPSA, s 30] and this section has provided for a test of priorities with the result that the so-called doctrine of actual notice cannot prevail. It was further argued that the plaintiff had a purchase-money security interest, that s. 21 defines when a security interest is perfected and that s. 25 covers the question of perfection by registration.

The thrust of this argument was that if no other provision of the Personal Property Security Act is applicable the provisions of s. 35 apply since both security interests were registered with the result that priority would be determined by s. 35(1)(a) by the order of registration if the security interests have been perfected by registration.

The submission made by counsel for the plaintiff was that the legislation did not specifically abolish the doctrine of actual notice. My attention was directed to s. 22(1)(a) wherein it is clear that an unperfected security interest is subordinate to the interest of a person who is entitled to a priority under the Personal Property Security Act or any other Act. To decide who is entitled to priority it is necessary to peruse s. 35(1). It was said that cls. (a) and (b) had no application because under (a) both security interests were registered and under (b) both were perfected. In other words s. 35(1)(a) and (b) are of no assistance in resolving the issue in this application because here the contest is between one perfected and one unperfected security interest. The question really involves whether the defendants are entitled to a priority under s. 22(1) [current OPPSA, s 20] of the Personal Property Security Act. The conclusion I was invited to reach was that the only purpose of requiring registration was to give notice to third parties and that if, in fact, a third party has acquired knowledge of the security interest then the underlying requirement has been met.

I reserved judgment on this application because the legislation is relatively new and the academic writers have indicated that there are conflicting policy arguments with an unresolved problem.

It was said that there is an omission in s. 35(1) which could easily have been rectified by the legislative draftsman so that the case at bar could have been covered. It was also said, with some force, that the doctrine of actual notice is deeply rooted in our law and that one of the well-known rules of statutory interpretation is that the provisions of the common law cannot be changed without an express statutory provision to that effect.

I have considered the following cases: Re Jung and Montgomery, [1955] O.W.N. 931, [1955] 5 DLR 287; Pitcher v. Shoebottom, [1971] 1 OR 106, 14 D.L.R. (3d) 522; Re Dominion Stores Ltd. and United Trust Co. (1973), 2 O.R. (2d) 279, 42 DLR (3d) 523 …

These cases generally stand for the proposition in cases involving the Land Titles Act, R.S.O. 1970, c. 234, as amended, that "the doctrine of actual notice as to all contractual relations and particularly the law of real property has been firmly based in law since the beginning of equity. Such a cardinal principle of property law cannot be considered abrogated unless the legislative enactment is in the clearest and most unequivocal of terms." This latter phrase was used by Spence J. in delivering the majority decision in the Supreme Court of Canada in United Trust Company v. Dominion Stores et al., supra.

I have come to the conclusion that this application should succeed. The provisions of the Personal Property Security Act to some extent flow from the earlier provisions of the U.S. Uniform Commercial Code. Although the language is different it is interesting to compare s. 9—312 of the U.C.C. with s. 35 of the Personal Property Security Act. The language is similar and notice makes no difference Bloom v. Hilty (1967), 234 A. 2d 860.

In my view nothing in s. 35 says anything about lack of knowledge being a prerequisite for its operation.

In an action in the County Court of the Judicial District of Ottawa-Carleton between the Bank of Nova Scotia v. Dilauri Chevrolet Oldsmobile Ltd., the plaintiff bank with prior registration succeeded even though it had notice. Judge E. E. Smith made the following statement:

> It is argued that as between the two claimants in this case, the Bank of Nova Scotia and Dilauri Chevrolet Oldsmobile Ltd., a subsequent registration by the Bank ought not to be allowed to prevail where there was actual notice. It is conceded that Dilauri's failure to comply with the Act was innocent and in no way misled the Bank.
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> If I were to accede to the argument, it seems to me that I would be reading into this rather comprehensive piece of legislation something which was (deliberately—the concept of actual notice being well known to the drafters) omitted and in the process thwarting many of the obvious purposes of the legislation.
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> In the present case I adopt that reasoning and that language.

I would also adopt the language of Lord Cozens-Hardy M.R. in Re Monolithic Building Company; Tacon v. The Company, [1915] 1 Ch. 643, at 665-6 [who,] quoting James L.J. in an earlier case [Edwards v. Edwards (1876), 2 Ch.D. 291 at p. 295], said:I think it would be dangerous to engraft an equitable exception upon a modern Act of Parliament,"and at p. 666 [Edwards v. Edwards, p. 296]:

> Both parties stood on their legal rights—neither of them was misleading the other. It is not consistent with the policy of the Legislature to import fine equitable distinctions into these cases, and I am therefore of opinion that the argument founded on the knowledge of the judgment creditor cannot prevail.

I have likewise reviewed ss. 36 and 37 [current OPPSA, ss 34-35] and have concluded that the special priority rules thereunder have no connection with this application. The plaintiff's submission depends on looking to see a fixed time for registration but there is nothing in the Personal Property Security Act that fixes the time when the Court looks to see if there has been registration. This is a new statute which should be dealt with upon its own merits rather than some considerations which might apply to the Land Titles Act. Sections 22 and 36(3) contemplate knowledge but it is my view that this appears in the Personal Security Act for two situations and I draw the inference that the actual notice principal doesn't therefore apply elsewhere in the Act.

Professor R. H. McLaren in his textbook Secured Transactions in Personal Property in Canada, vol. 1 (1979), pp. 6—2-6—3, states the general or residual rule [of] s. 35 thus:

> The general rule of priority is built around the key concepts of attachment and perfection. No other statute has ever attempted to state even a single priority rule let alone one of such general application as s. 35. If no special priority rule governs then the rules of subs. (1) are used to resolve competing claims in the same collateral.
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> The three rules of s. 35 disregard the pre-Act law and its reverence for legal title to the collateral and application of the equitable principle of good faith and notice.

I adopt the foregoing and am reinforced in my view by the judgment of Laskin C.J.C. in United Trust v. Dominion Stores, supra, albeit a dissenting judgment.

Judgment for defendant.

NOTES

1. For another judgment to the same effect, see *National Trailer Convoy of Canada Ltd v Bank of Montreal*[5] and other cases cited in Ziegel, Denomme & Duggan.[6] The policy considerations are summarized in Ziegel, Denomme & Duggan as follows:

> The main policy reason for making knowledge irrelevant is that inquiries into knowledge are expensive and time consuming. On the other hand, a bright line priority rule, which turns solely on the order of registration or perfection, saves litigation costs by keeping the inquiries simple and facilitates settlement by increasing the predictability of case outcomes.[7]

2. While knowledge of the interests of a competing claimant is not relevant under s 30(1), it is relevant in other circumstances under the OPPSA, including a contest governed by either of s 20(1)(c) or (d),[8] the conflict of law rule in s 5(2), and a sale contemplated by ss 28(4) and 28(5). Why should the competing claimant's knowledge be relevant in some contexts but not others? See Chapter 4, Section VI.E.4 discussing this question in the context of ss 20(1)(c) and (d). Do the same considerations apply in the context of ss 5(2), 28(4), and 28(5)?

IV. PRIOR LENDER'S COMPETITIVE ADVANTAGE

With certain exceptions (for example, investment property and chattel paper), secured parties in Ontario and the other Canadian PPSA jurisdictions will usually perfect by registration. Accordingly, most contests between secured parties will be resolved through the application

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5 (1980), 1 PPSAC 87, 10 BLR 196 (Ont H Ct J).

6 Jacob S Ziegel, David L Denomme & Anthony Duggan, *Ontario Personal Property Security Act: Commentary and Analysis,* 3rd ed (Toronto: LexisNexis Canada, 2020) at 272, fn 196.

7 *Ibid* at 272.

8 Although the OBA has recommended the deletion of these knowledge requirements: Ontario Bar Association, *Submission on Recommendations to Modernize and Harmonize Ontario's Personal Property Security Act and Repair and Storage Liens Act* (6 August 2010) [OBA 2010 Submission].

of s 30(1), rule 1 (first to register). The first to register priority rule gives the prior secured lender a significant advantage, particularly having regard to s 30(3) (priority for future advances, discussed in Section VI below); s 45(3) (registration in advance of security agreement); and s 45(4) (use of a financing statement to perfect multiple security interests in the same collateral type) (ss 45(3) and (4) are discussed in Chapter 5, Section II.B).

Example 2

Day 1. Debtor has a delivery business and borrows $25,000 from SP1. Debtor gives SP1 a security interest in their delivery truck under a written security agreement.
Day 10. SP1 properly registers a financing statement.
Day 20. The loan is fully paid off, and SP1 returns the security agreement to Debtor marked "Repaid." SP1, however, does not discharge its filing, and Debtor never thinks to ask that it do so.
Day 30. Debtor provides SP2 with a credit facility secured against the same truck pursuant to a written security agreement, and SP2 properly registers a financing statement. SP2 searches and sees the SP1 filing but is told by Debtor that SP1's loan was paid out and, as evidence, Debtor shows SP2 the security agreement with the "Repaid" notation on it.
Day 100. SP1 makes a new loan to Debtor on the security of the same truck pursuant to a new security agreement signed by Debtor.

1. Who has priority as between SP1 and SP2 with respect to the truck?
2. Would it make a difference to the answer if the truck was driven by Debtor mostly for personal use?
3. Would it make a difference to the answer if on Day 30, SP2 had, pursuant to s 18 of the OPPSA, asked SP1 for a statement of the amount owing and SP1 had returned the copy of the security agreement marked "Repaid"?
4. What should SP2 have done to avoid the risks this example highlights?

Example 2 illustrates the operation of s 30(1), rule 1 and the operation of each of ss 45(3) and 45(4) as well as the fact that, except for consumer goods, a secured party has no independent obligation to discharge its registration unless requested by the debtor (which the debtor may do under s 56).[9]

As to Question 1, SP1 wins based on s 30(1), rule 1—first to register. Since the collateral is not consumer goods, SP1 can rely on its filing even though it was initially made for a different loan that was repaid (s 45(4)). The older registration may have been made in a different context, but unless self-limiting through a collateral description, it is available to shelter later transactions. As well, s 45(3) permits the filing to be made before the security agreement has been signed, so the fact that the new security agreement was signed after SP1's original filing does not prevent the filing from perfecting SP1's security interest.

As to Question 2, if the truck were driven by Debtor mostly for personal use, it would have been "consumer goods" and, in that case, s 45(4) would not have applied. Accordingly, SP1 could not have relied on its original filing. This means that SP1 would have been unperfected, and therefore SP2 would have won based on s 20(1)(a)(i). In addition (as discussed in Chapter 5, Section IV.G.3), because the truck was consumer goods, once Debtor has performed all of their obligations, s 57 requires SP1 to file a discharge of its OPPSA registration within 30 days without the need for a request from the debtor.

As to Question 3, SP2 was entitled under s 18 to request a statement of the amount owing from SP1. On the facts of Question 3, SP1 complied with that request and its reply was accurate as of the date of the reply. The issue then is whether SP1, knowing that SP2 was relying on

9 A discharge of a registration is not to be confused with a release or discharge of the security interest. To discharge a registration, the secured party must register a financing change statement; this does not discharge the security interest, but simply results in the security interest becoming unperfected.

SP1's reply, was under any obligation to notify SP2 before making a new advance and entering into a new security agreement; more specifically, in failing to provide such a notice, might it be argued that SP1 is subordinated to SP2 or, alternatively, that it is estopped from relying on its filing? SP2 might well make these arguments, but it would probably not succeed unless SP1 had said more than the facts here suggest. The better course for SP2 would have been as discussed below.

As to Question 4, Example 2 demonstrates the risks SP2 assumed in proceeding with its transaction in the circumstances. What could SP2 have done to avoid these risks? Some of the options that SP2 could have considered are described below.

First, SP2 could have insisted that Debtor require SP1 to discharge the earlier filing or amend it by inserting a collateral description excluding the truck (see OPPSA, s 56). Debtor may or may not have wanted to comply, depending on how likely they thought it was that SP1 would later go ahead with a new loan, but the relative bargaining power of the parties would determine the outcome.

Second, SP2 could have requested an estoppel letter from SP1 confirming that SP1 would not rely on its filing to perfect a security interest in the truck (see the discussion on estoppel letters in Section VIII.D below).

Third, as a variation on an estoppel letter but to similar effect, SP2 could have insisted on a subordination agreement from SP1 subordinating its interest in the truck in favour of SP2 (see the discussion on subordination agreements in Section VIII below).

Fourth, if the facts were that SP2 was financing Debtor's acquisition of the relevant collateral, SP2 might have been entitled to the super-priority associated with a purchase-money security interest assuming it complied with the relevant requirements in s 33 of the OPPSA. (See Chapter 7 on purchase-money security interests.)

Lastly, if instead of inventory the collateral was either investment property or electronic chattel paper, SP2 might have been able to obtain priority by relying on control to perfect (see s 33.1 for investment property, and s 28(3) for electronic chattel paper). If the collateral were tangible chattel paper, SP2 might have been able to obtain priority by relying on possession—see s 28(3). (Section 28 is discussed in Chapter 9.)

V. TIME FOR DETERMINING PRIORITIES

In most cases involving a competition between unperfected security interests, at least one of the secured parties will realize sooner or later that its security interest is unperfected, and it will register a financing statement or otherwise perfect its security interest. If one secured party perfects, but the other does not, the dispute will be governed by OPPSA, s 20(1)(a)(i), while if both secured parties perfect, the general priority rules in s 30(1) will apply, unless a special priority rule applies (for example, s 33, which governs the priority of purchase-money security interests). At what point does it become too late for a secured party to perfect its security interest (or, in other words, when do we take our snapshot and freeze the facts, so we can assess each party's position)? In Chapter 4, Section VI.F, we considered similar questions in the context of s 20(2) and contests between an unperfected security interest and a trustee in bankruptcy or certain lien claimants, but s 20(2) does not address timing for contests between secured parties.

In *Sperry Inc v Canadian Imperial Bank of Commerce*,[10] discussed in Chapter 4, Section VI.F, SP1 and SP2 held competing unperfected security interests in the debtor's farm equipment. The debtor defaulted, and SP1 appointed a receiver. SP2 registered a financing statement 11 days later. SP2 argued that its perfected security interest had priority over SP1's

10 1985 CanLII 1934, 17 DLR (4th) 236 (Ont CA).

unperfected security interest. The Court rejected the argument, holding that the priority issue should be resolved by reference to the time at which the security interests came into conflict. This occurred when SP1 enforced its security interest by appointing the receiver or, alternatively, when Sperry (SP1) attended at the premises and attempted to remove the collateral.

The *Sperry* case has been followed in a number of other Canadian decisions (see, for example, *John Deere Credit Inc v Standard Oilfield Services Inc*[11]), and also, in New Zealand (*Gibbston Downs Wines Limited and RFD Finance No 2 Limited v Perpetual Trust Limited*[12]). In Australia, the Whittaker report[13] has recommended amending the PPSA to codify the *Sperry* ruling.

However, the concept of looking to when the security interests come into conflict can lead to uncertainty. Even in the *Sperry* case itself, the Court accepted that the conflict could have arisen on either of two different dates. In addition, the decision has been questioned: see Ziegel, Denomme & Duggan.[14] See also Richard McLaren, *Secured Transactions in Personal Property in Canada*,[15] suggesting that the general principle for fixing the time or date at which priority is to be determined is, in the absence of other factors, the date on which a secured party acts to realize upon its security.

How should this uncertainty be resolved? First, in most cases, the unperfected secured party will, as soon as it discovers the issue, take steps to perfect. This may or may not give it priority against another secured party, but assuming a trustee in bankruptcy has not yet been appointed, it will at least give the secured party a prior position as against the trustee. In addition, if the security interest was previously perfected by registration but the registration has lapsed or been discharged, a new filing may give continuous perfection under s 30(6) and perhaps resolve the problem.

The CCPPSL Report extracted below takes a different view; it outlines the competing policy considerations, and it explains the reasons underlying its recommendation.

Canadian Conference on Personal Property Security Law, Report on Proposals for Changes to the Personal Property Security Acts

(21-23 June 2017), Part II(6)

Time For Determining the Priority of a Security Interest

(a) Background

As a practical matter, priority as between security interests will typically be determined when a secured party takes action to enforce its security interest after the debtor defaults. The priority ranking will determine both the hierarchy according to which funds generated by disposition of the collateral are distributed and the title of a person who buys the collateral in the enforcement proceedings. In a number of cases, a question has arisen as to whether the priority ranking of the security

11 2000 CanLII 28252, 258 AR 266 (QB).

12 [2012] NZHC 1022.

13 Bruce Whittaker, *Review of the Personal Property Securities Act 2009: Final Report* (Commonwealth of Australia, 2015) at para 7.7.1.

14 *Supra* note 6 at 278-79.

15 3rd Binder (loose-leaf subscription), s 7(1).

interest or interests involved, as determined when enforcement measures are taken, is altered by either a subsequent loss of perfection (typically through the lapse or discharge of a secured party's registration) or the establishment of perfection through fulfilment of a perfecting step (typically by a registration having been made). In other words, are priorities fixed as at the date enforcement measures are initiated?

The cases addressing the issue generally involve the enforcement of a security agreement through the appointment of a receiver authorized to take possession of and sell collateral comprising much or all of a business debtor's asset base to satisfy the secured debt. The appointment may be made either by a secured party acting extrajudicially under the terms of the security agreement or by order of the court on application of the secured party. The date of the receiver's appointment has been identified as the relevant date for determining priorities. Where the secured party enforces directly through seizure of the collateral, the date of seizure might be viewed as the analogous date. While there are no cases on point dealing with enforcement against an account or other intangible collateral, the date on which notice is given to the account debtor or obligor directing payment to the secured party may be considered the date of enforcement (see [Saskatchewan] PPSA s 57(2)).

[The report then sets out different scenarios in which the priority status of secured parties changes after commencement of enforcement.]

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The problem illustrated by these scenarios rarely arises, since secured parties should and will ordinarily take care to ensure that they have effected and maintained a valid registration to establish and preserve a priority ranking. However, in the relatively few reported cases in which it is has arisen, the courts have concluded that priority is to be determined as at the date of enforcement action and, implicitly, is unaffected by subsequent changes in the registered status of one or more of the competing interests involved (see especially *Sperry v Canadian Imperial Bank of Commerce*, referred to in several subsequent cases). On this view, if at the date of enforcement a security interest is perfected by registration, the priority status flowing from perfection continues even if the registration subsequently lapses or is discharged and the security interest loses its perfected status. Similarly, if both interests are unperfected at the date of enforcement, priority goes to the first to attach and subsequent registration by one of the secured parties does not alter the outcome.

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A potential change in priority ranking after enforcement measures have been taken by a secured party can have very serious consequences. In practice, enforcement will be initiated only by a secured party who has priority over competing interests, since an enforcing creditor is assured of recovering their claim only to the extent that their interest has priority. A secured party who undertakes enforcement may incur very substantial expenses through a potentially extended process of disposing of the collateral, particularly where a receivership is involved. A party whose security interest loses priority during the process of enforcement as a result of an inadvertent lapse in registration may find themselves unable to complete the process of sale without paying out others whose interests have correspondingly assumed priority over their own, potentially defeating the enforcing creditor's expectation of recovering some or all of the secured debt as well as the expenses incurred in enforcement. At the same time, a party who knew or was in a position to know that their interest was subordinate to that of the enforcing creditor when they chose to extend funds or credit may be viewed as having garnered an undeserved windfall if they are thrust into a priority position through a clerical error or inadvertence on the part of the creditor who initially enjoyed priority.

The judicial view that priorities are established at the date of enforcement action and not affected by subsequent registry changes is likely informed by perceived considerations of fairness based on the consequences just described … .

While this view may appeal to the courts and others for the practical reasons suggested, it is inconsistent with the approach to priority embodied in the explicit rules of the PPSA. The priority of a security interest depends on the fact and time of attachment and perfection. Seizure of collateral or a corresponding enforcement step does not affect the debtor's interest in the property and is not a factor in the operation of any priority rule. Perfection plays a critical role in the priority system because it is the condition that allows third parties who might deal with a debtor to ascertain that the debtor's property is subject to a property interest that might otherwise be unknown. A secured party can control the risk of subordination to competing claims by ensuring that its interest is properly registered and that the registration is maintained. A secured creditor whose registration lapses is given some measure of protection by SPPSA s 35(7), but the limited scope of that protection implicitly contradicts the view that priority is preserved in cases other than those that fall within the rule.

A statutory formulation of the judicial rule that would effectively freeze priorities at the date of enforcement carries the risk that a person who acquires an interest or makes an advance to a debtor after enforcement action is initiated will be subordinated to an undiscoverable interest. In the scenarios outlined, SP2 would be subordinate to SP1 with respect to a post-enforcement advance even though SP2 might have searched the registry and relied on a search result that does not disclose SP1's interest. This undermines the function of the registry system, which is designed to ensure that third parties can rely on a search result in determining whether and to what extent to advance credit or lend funds to a debtor. If priorities are fixed at the date when SP1 appointed a receiver or took another enforcement measure, SP2 will lose out to SP1 not only with respect to any funds initially advanced but also with respect to the advance made while SP1's interest was off the registry.

One might conclude that the problem is sufficiently resolved by the existing case law. However, the cases are small in number and limited to a few jurisdictions, and the reasoning advanced is not beyond challenge. As a result, there is significant uncertainty as to the strength and scope of the judicial rule that would fix priorities at the date enforcement is commenced.

A legislative solution through amendment of the Act is required, both to resolve the uncertainty raised by the cases and to implement a fully considered policy choice. Stated generally, the alternative policy choices outlined above could be implemented by either:

1. adding a statutory rule stating expressly that the initiation of enforcement does not affect the priority of a security interest, or
2. adding a statutory rule stating expressly that priority as between security interests is not affected by a change in the perfected status of either interest that occurs after the initiation of enforcement with respect to one of them.

(b) Recommendation

The view that a clear rule should be enacted to establish the date at which priority as between security interests is fixed is beyond debate. While there may be a difference of opinion among lawyers and others as to the policy that should be implemented by the rule, the approach recommended is the first option outlined above: the Act should be amended to include a rule expressly stating that the initiation of enforcement does not affect the priority of a security interest.

The PPSA adopts as a fundamental principle the concept that priority is based on the perfected or unperfected status of a security interest. This in turn advances the operational policy of ensuring that creditors and potential creditors are in a position to determine the existence of prior claims against a debtor's assets through a registry search, and to make lending and credit decisions accordingly. While there are a few instances in which a security interest may acquire priority through a perfecting step other than registration, the alternative perfecting steps are designed to alert competing creditors to the existence of a prior security interest through other means.

A rule that would fix priorities when enforcement is initiated would allow a secured party who has not perfected its interest before taking action or who has allowed the perfected status of its interest to lapse to assert priority. This approach may be justified by the view that competing parties are in practice unlikely to advance funds or grant credit to the debtor after enforcement proceedings are commenced. The approach recommended is based on the alternate view that competing parties may act on the basis of a search result that does not disclose the enforcing creditor's interest. A secured party who wishes to take enforcement action can protect its priority position by ensuring that its interest is perfected and remains so until enforcement proceedings are completed. As between the enforcing creditor and a competitor, the enforcing creditor is in the best position to manage the risk of recovering its claim.

The recommended approach also has the advantage of simplicity in the language and application of the statutory rule. A rule fixing priorities at the time of enforcement would require supplementary rules defining the time at which enforcement is initiated under the various types of enforcement action that might be used, taking into account the range of circumstances in which it might occur. The range of potential cases that must be addressed would include enforcement through direct seizure of tangible collateral by a secured creditor, notification of account debtors in the collection of accounts, the appointment of a receiver under the terms of a security agreement or by the court, and retention of collateral in satisfaction of the secured debt. In some instances, it would be difficult to define the initiation of enforcement in such a manner that the relevant time could be clearly identified and readily ascertained.

The recommended approach subjects secured creditors to potential loss of priority due to an inadvertent or unauthorized lapse in registration, or a registration discharge resulting from failure to respond to notice of a third-party demand to discharge under SPPSA section 50. However, these risks can be ameliorated by appropriate monitoring practices on the part of secured parties. The Acts generally provide a 30-day window of time after a registration lapses or is discharged within which the secured party may reinstate the registration and thereby maintain the priority of the security interest as against security interests that were subordinate before the lapse or discharge occurred (see SPPSA s 35(7)). In Ontario, the period of time during which priority may be restored by re-registering is unrestricted (see Ontario PPSA s 30(6)). …

The rule proposed has the effect of fixing priority as between security interests at the time that title to the collateral is transferred to a buyer or transferee in enforcement proceedings. This means that a change in priority ranking that occurs after the initiation of enforcement may affect the title of a person who has bought or agreed to buy the collateral. The buyer will take subject to a security interest that has assumed priority over the interest of the enforcing creditor. However, a buyer in that position is not entirely vulnerable. Where the sale is conducted by the secured party or a privately appointed receiver, the buyer would have recourse against the secured party who has had the collateral sold without ensuring that it has priority. Where a court-appointed receiver is involved, the court will presumably not approve a sale without confirmation of the priority status of competing claims.

The recommended approach is consistent with United States law, though Article 9 does not address the issue directly. It does not conflict with the Ontario rule under which a secured party may perfect a security interest by taking possession of collateral for purposes of enforcement. If further certainty is required in Ontario, the rule could be made expressly subject to OPPSA section 22.

VI. SECURITY FOR FUTURE ADVANCES

A. INTRODUCTION

Consider the following example.

Example 3

On June 1, SP1 opens a line of credit in Debtor's favour secured by a security interest in Debtor's inventory. On the same date, SP1 registers a financing statement and Debtor draws down $60. On July 1, SP2 and Debtor enter into a security agreement, giving SP2 a security interest in the same inventory. On the same date, SP2 registers a financing statement and makes Debtor a loan of $30. On August 1, Debtor draws an additional $50 on its line of credit with SP1. On September 1, Debtor defaults against SP1 and SP2 and, on that date, the value of Debtor's inventory is $100. SP1 claims the inventory for its June 1 and August 1 advances. SP2 argues that its claim to the inventory in relation to SP2's July 1 advance has priority over SP1's claim to the inventory in relation to SP1's August 1 advance.

B. THE LAW

Prior to the enactment of the PPSAs, the type of dispute described above was governed by the equitable doctrine of "tacking." The rule was that SP1 had priority over SP2 for the August 1 advance, but not if SP1 had notice of SP2's July 1 loan: *Hopkinson v Rolt*;[16] The rule applied whether or not SP1 was under a commitment to make the August 1 advance: *West v Williams*.[17] "Notice" meant actual knowledge of SP2's security interest, as opposed to constructive notice deriving from SP2's registration.

The PPSAs replace the tacking doctrine with a set of statutory rules. In Ontario, the governing provisions are OPPSA, s 13 read in conjunction with s 30(3). Section 13 provides that a security agreement may secure future advances, while s 30(3) provides that, where future advances are made while a security interest is perfected, the security interest has the same priority with respect to each future advance as it has with respect to the first advance. Note that SP1's state of knowledge of the other security interest is irrelevant (although see the discussion below on s 30(4)). Why?

Section 1(1) defines "future advance" to mean "the advance of money, credit or other value secured by a security agreement *whether or not such advance is given pursuant to commitment*" (emphasis added). In Example 3, there is nothing to suggest that SP1 has a discre-

16 (1861), 9 HLC 514, 11 ER 829 (HL).

17 [1899] 1 Ch 132 (CA).

tion to refuse the August 1 advance. On this basis, the loan is given pursuant to commitment, it is a "future advance," and so ss 13 and 30(3) apply. Suppose that the agreement between SP1 and Debtor had expressly given SP1 the option of declining to provide further credit at any time unless satisfied that it was sufficiently secured. This case is covered by the closing part of the definition; SP1's August 1 advance is still a "future advance," and ss 13 and 30(3) still apply.

C. POLICY CONSIDERATIONS

In Example 3, the effect of the statute is to give SP1 a competitive advantage over SP2 and to force SP2 to negotiate a subordination agreement with SP1 if SP2 wants to be sure of its priority position in relation to its July 1 loan. The policy justification for giving SP1 priority over SP2 for its August 1 advance, despite these consequences, is that it saves transaction costs by allowing SP1 to make subsequent advances "without each time having, as a condition of protection, to check for filings later than his."[18] However, from Debtor's point of view, the statute increases the costs of subsequent borrowings from junior creditors. Particularly in fact situations like the one in Example 3, which involve revolving credit arrangements, it is probably safe to assume that the benefits to Debtor exceed the costs.

There is another relevant consideration. Consider the following variation on Example 3:

> On June 1, SP1 agrees to lend Debtor $110, on the basis that Debtor will receive $60 immediately and the remaining $50 on August 1. Debtor gives SP1 a security interest in its inventory to secure repayment, and SP1 registers a financing statement. All other facts in Example 3 remain the same.

The contract between SP1 and Debtor is in substance a single contract for the loan of $110, which is advanced by SP1 in two drawdowns. If SP1 had paid Debtor the $110 in full right at the outset, SP1 would clearly have had priority over SP2 for the whole amount. In principle, it should make no difference that SP1 advanced the loan to Debtor in multiple drawdowns because it is the substance of the transaction, not its form, that should govern.

This analysis only holds if SP1 is under a commitment to make the August 1 payment. If SP1 has a discretion, then the transaction between SP1 and Debtor is the same in substance as if SP1 had made two separate loans to Debtor. Assume that this is, in fact, what happens:

> On June 1, SP1 agrees to lend Debtor $60. Debtor gives SP1 a security interest in its inventory to secure repayment, and SP1 registers a financing statement. On August 1, SP1 agrees to lend Debtor a further $50 and takes a security interest for this new loan under a separate security agreement, also in Debtor's inventory. All other facts in Example 3 remain the same.

On these facts, SP1's August 1 payment is not a "future advance" because it is subject to a separate security agreement ("'future advance' means the advance of money … secured by *a* security agreement" [emphasis added]). Therefore, ss 13 and 30(3) do not apply. However, that is not the end of the story: by virtue of OPPSA, s 45(4), SP1's June 1 registration is sufficient to perfect both its June 1 and August 1 security interests and, since priority between SP1 and SP2 turns on the order of registration (s 30(1), rule 1), SP1 still has priority over SP2 for the August 1 advance. In principle, the outcome should be the same in the analogous case where SP1 and Debtor's June 1 security agreement contemplates future advances but without any commitment on SP1's part. To treat the two cases differently would be to elevate form over substance. The point for present purposes is simply that whatever the priority rule, it should be the same for both transactions.

18 See Thomas H Jackson & Anthony T Kronman, "Secured Financing and Priorities Among Creditors" (1979) 88 Yale LJ 1143 at 1180, quoting Article 9, s 9-312, Comment 5.

Another reason for having the OPPSA, s 30(3) priority rule apply whether or not SP1 was under a commitment to make the August 1 payment is to save litigation costs by avoiding case-by-case inquiries into whether SP1 was subject to a commitment or not. The following passage explains the issue:

> The distinction between advances under commitment and optional advances no doubt must arise out of the nature of the conditions which will and will not excuse the lender's performance. Clearly, a lender's commitment to make a future advance which excuses performance if he dislikes the way the debtor has parted his hair on the day the latter asks for the advance is not a real commitment. It is quite a different matter, however, if the lender's commitment to make an advance is excused only if the debtor's balance sheet, audited by an independent accountant, shows that the debtor's net current asset-debt ratio has fallen below an agreed-upon, reasonable standard.[19]

D. FUTURE ADVANCES AND EXECUTION CREDITORS

Section 30(3) is subject to the exceptions set out in s 30(4), which apply when the contest is between the creditor making the future advance and any of the third parties referred to in s 20(1)(a)(ii) or (iii), being essentially execution creditors and others entitled to share in their recoveries. In this context, the rules differ significantly from s 30(3), turning back to both knowledge as well as the presence of a commitment. Specifically, the future advance will be subordinate to any such persons if made after the secured party receives written notification of the interest of any such person unless the advance is made to pay reasonable expenses or under a commitment to advance. The commitment exception applies even if the commitment has fallen away due to "a subsequent event of default or other event not within the secured party's control" which has relieved the secured party from the commitment (s 30(4)(b)).

VII. PRIORITY OF REPERFECTED SECURITY INTERESTS

Consider the following example.

> Example 4
>
> On Day 1, SP1 takes a security interest in Debtor's pickup truck and registers a financing statement for a one-year period. On Day 30, SP2 takes a security interest in the same pickup truck and registers a financing statement. SP1's security interest becomes unperfected on Day 366 due to SP1's failure to renew on time. On Day 400, SP1 reperfects its security interest by registering a new financing statement. On Day 450, Debtor defaults. SP1 and SP2 both claim the truck.

In this example, SP1's security interest became unperfected due to a failure to renew on time. It might have become unperfected for other reasons as well (as described in Chapter 5), such as:

- If Debtor's name changes and SP1 fails to register a financing change statement within the s 48(3) grace period, SP1 will be unperfected from the end of the grace period until it registers a financing change statement or financing statement, as applicable.
- If Debtor transfers its interest in the collateral to T and SP1 fails to register a financing change statement within the grace period specified in s 48(1) or 48(2), SP1 will be unperfected from the end of the grace period until it registers a financing change statement or financing statement, as applicable.

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19 PF Coogan, "The New UCC Article 9" (1972-73) 86 Harv L Rev 477 at 505-7.

OPPSA, s 30(6) is relevant in cases like Example 4. It provides as follows:

> 30(6) Where a security interest that is perfected by registration becomes unperfected and is again perfected by registration, the security interest shall be deemed to have been continuously perfected from the time of first perfection except that if a person acquired rights in all or part of the collateral during the period when the security interest was unperfected, the registration shall not be effective as against the person who acquired the rights during such period.

In Example 4, since SP2 did not acquire any rights during the period of unperfection (the "gap period") it has not been prejudiced and therefore should not gain a windfall from SP1's mistake. Applying the first part of s 30(6) to Example 4, the result is that SP1 has priority over SP2 under s 30(1) rule 1.

Let us change the facts in Example 4 slightly so that SP2's dealing with Debtor takes place on Day 370 rather than on Day 30. All other facts remain the same. Since SP2 acquired rights during the period that SP1 was unperfected, the second part of s 30(6) applies, and SP2 has priority over SP1 to the extent of the rights so acquired. In contrast to the first version of Example 4, SP2 has potentially been prejudiced by SP1's failure to maintain its perfection. For example, if SP1 became unperfected due to a failure to renew, at some point after the end of the renewal period, SP1's security interest would become unsearchable, and in that case, SP2 would have had no way of knowing that there was a prior secured party entitled to priority at the time of SP2's dealing with Debtor. If SP1 became unperfected due to a failure to comply with s 48(3), SP2 might have searched against Debtor's new name and not discovered the SP1 filing. Having said this, there are certainly situations where SP2 will not have been prejudiced or will have had ample means to avoid the prejudice (such as searching against both Debtor's current and previous names) and therefore does gain a windfall due to SP1's mistake. Also, as we will see below, the parties entitled to benefit from the gap period are not limited to other secured parties, and some (such as a trustee in bankruptcy) are arguably not in any way prejudiced since their actions are not dependent on SP1 having become unperfected.

For an actual example of s 30(6) in operation, see the *Heidelberg Canada Graphic Equipment*[20] case, extracted in Chapter 5, Section IV.D. In *Heidelberg*, the Court concluded that s 30(6) "only protects a creditor who acquires some new rights in the collateral during the unperfected period."[21] This statement must be taken in context; the section is not limited in its effect to rights of creditors. Would a trustee in bankruptcy qualify? The decision in *1231640 Ontario Inc (Re)*,[22] discussed in Chapter 4, Section VI.D, clearly suggests it would.

There are still many unanswered questions regarding the interpretation of s 30(6). For example, are the categories of "persons" referred to in the section broader and more numerous than the persons mentioned in s 20 who have priority over an unperfected security interest? What if the person acquiring an interest during the period of unperfection is a buyer of the collateral who was aware at the time of the purchase that the collateral was subject to the unperfected security interest? In that regard, compare s 30(6) with s 20(1)(c) and the test there that the buyer not have knowledge of the security interest. What if SP2 acquires a security interest in a newly acquired asset of the Debtor during the gap period pursuant to an after-acquired property clause in its security agreement? Is that an acquisition of rights for the purposes of s 30(6)? Does it make a difference if the after-acquired asset is inventory that is constantly being bought and sold by Debtor?

Other questions relating to s 30(6) generally are as follows:

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20 (1992), 7 BLR (2d) 236, 4 PPSAC (2d) 116 (Ont Gen Div) [*Heidelberg* cited to BLR].

21 *Ibid* at para 48.

22 2007 ONCA 810.

1. Section 30(6) does not apply where the security interest was originally perfected by possession. Why should a distinction be drawn between a security interest perfected by registration and a security interest perfected by other means?
2. Does s 30(6) apply where the original registration occurred outside Ontario and there was a gap in re-registration after the collateral was brought into Ontario? (See Chapter 13 on conflict of laws questions.)
3. Should there be a limit on the amount of time that can pass between discharge or lapse and reperfection, as there is in the other provinces? See, for example, s 35(7) of the SPPSA, which provides as follows:

> 35(7) Where:
> (a) registration of a security interest:
> (i) lapses as a result of a failure to renew the registration; or
> (ii) is discharged without authorization or in error; and
> (b) the secured party registers the security interest not later than 30 days after the lapse or discharge;
>
> the lapse or discharge does not affect the priority status of the security interest in relation to a competing perfected security interest that, immediately prior to the lapse or discharge, had a subordinate priority position, except to the extent that the competing security interest secures advances made or contracted for after the lapse or discharge and prior to the re-registration.

4. Given the importance that the OPPSA elsewhere attaches to continuous perfection, what is the justification for making an exception in the case s 30(6) addresses?

VIII. SUBORDINATION AGREEMENTS

A. SUBORDINATIONS

Subordination agreements, and subordination clauses in security agreements, are very common. A *subordination agreement* is an agreement between one or more prior in time secured parties (SP1) and one or more subsequent in time secured parties (SP2) where SP1 agrees to subordinate its security interest to the security interest of SP2. In doing this, SP1 is not acting out of a spirit of altruism; rather, it is in its interest not to foreclose the debtor's access to other sources of credit that will only be made available if there is a subordination.

Subordinations are common in the context of shareholder loans, as illustrated in the following example.

Example 5

Day 1. Jo and Pat incorporate a new corporation, JP Retailers Ltd (JP). They determine that JP will need $100,000 of capital to operate. One option would be for them to provide this amount as share capital (that is, by investing $100,000 in the shares of JP), but their lawyers tell them that if JP ever runs into financial difficulty, their equity will be last in line to be returned from whatever assets JP still has at that point. Nonetheless, for corporate, tax, and other reasons, JP needs to have some equity, so Jo and Pat decide to invest half of the required amount in equity but loan the rest and take security from JP for the loan (and any other amounts they may loan to JP from time to time) under a general security agreement.[23] They register their security interest under the OPPSA.

23 That is, a security agreement providing for a security interest in all the debtor's present and after-acquired personal property (or ALLPAAP): see the sample charging clause in Section 1 of Appendix A.

Day 50. JP arranges a $500,000 loan from Bank, also to be secured under a general security agreement. Bank is quite unhappy however when its lawyers tell it that Bank's security interest will rank behind Jo and Pat's security interest. Bank, therefore, tells Jo and Pat that they will need to subordinate their security interest to the security interest being taken by Bank, or Bank will not proceed with the loan. While Jo and Pat would prefer not to subordinate, they accept that it is the only way for JP to obtain outside financing.

A subordination agreement may also be entered into when the secured parties are not sure about their priority positions vis-á-vis each other (for example, an accounts receivable financer and an inventory financer) or are concerned about an overlap in the collateral covered by their respective agreements. The purpose of the subordination agreement in these circumstances is to resolve the uncertainty in advance and to reduce the risk of subsequent litigation.

A *subordination clause* differs from a subordination agreement. A subordination agreement is an agreement between the affected secured parties themselves. By contrast, a subordination clause is a provision in the security agreement (or perhaps some other agreement) between the secured party and the debtor by which the secured party subordinates its security interest to one or more other secured parties. Given the general concepts behind the third party beneficiary rule and the privity doctrine (albeit somewhat weakened in recent years), how can a clause in an agreement between the debtor and a secured party benefit another secured party who is not a party to the agreement? The normal rule at common law (again with some exceptions) is that third parties are not entitled to enforce provisions in an agreement to which they are not party. The answer is found in s 38 of the OPPSA.

OPPSA, s 38 provides that "a secured party may, *in the security agreement or otherwise*, subordinate the secured party's security interest to any other security interest and such subordination is effective according to its terms" (emphasis added). The provision reinforces the point that the OPPSA priority rules are default rules and that the parties can contract for a different priority order if they want to. In addition, given the phrase "in the security agreement or otherwise," SP1 and SP2 may deal directly, via a subordination agreement, or indirectly, via a subordination clause in the security agreement (or some other agreement) between SP1 and Debtor; since, in the latter case, SP2 is typically not a party to the agreement containing the subordination clause, s 38 must be intended to override the normal privity requirements.

This result was confirmed in *Euroclean Canada Inc v Forest Glade Investments Ltd*,[24] where the Ontario Court of Appeal held that OPPSA, s 38 creates an exception to the privity doctrine. The corresponding provision in the other provinces makes the point explicitly; for example, SPPSA, s 40(1) provides that the subordination provision may be enforced by a third party "if the third party is the person … for whose benefit the subordination was intended."

Accordingly, if SP1's security agreement has a clause stating that the security interest being granted shall be subordinate to any (or certain) security interests that may be granted to SP2, then SP2 can rely on and enforce the subordination in the event of a contest between SP1 and SP2, even though SP2 is not a party to SP1's security agreement or other agreement with the debtor. For a more detailed discussion of *Euroclean* and several related cases that explore when clauses give rise to a subordination and when they do not, see Chapter 7, Section V.

The security agreement and the credit agreement may be contained in the same document, but they are often documented separately. In the latter case, the subordination clause may be in the credit agreement, rather than in the security agreement. However, s 38 still applies given that the subordination may be "in the security agreement *or otherwise*" (emphasis added).

24 1985 CanLII 2236, 49 OR (2d) 769 (CA).

Euroclean settled the point that the beneficiary of a subordination clause is not required to perfect its security interest before it can invoke the clause, but it does not settle another issue that troubled US lawyers in the 1960s. This was whether a subordination clause or subordination agreement creates a security interest given by the senior secured creditor in favour of a junior secured creditor and must therefore be perfected under Article 9. To ensure that the courts would not reach this conclusion, UCC, s 1-209 (now s 1-310) was added in 1966, making it clear that a subordination clause does not create a security interest. There is a corresponding provision in the PPSAs outside Ontario, which provides, in effect, that a subordination *alone* does not create a security interest: see, for example, SPPSA, s 40(2). The wording suggests that if the subordination agreement has additional features, this may make a difference.

To elaborate, subordination agreements will sometimes contain a so-called turnover clause, under which SP1 promises that if it enforces its security interest, it will pay the proceeds to SP2 up to the value of the collateral. Assume the value of the collateral is $100. Debtor owes SP1, $70, and it owes SP2 $40. Under a turnover clause, SP1 promises to pay SP2 the first $40 out of the collateral sale proceeds. It might be argued that this involves the assignment of an account or at least part of an account. The account is the payment obligation Debtor owes SP1, and by agreeing to hand over the collection proceeds, in effect, SP1 is acknowledging a transfer of the entitlement. If this analysis is right, the transaction is a deemed security agreement by virtue of OPPSA, s 2(b), and so SP2 should register a financing statement. Otherwise, it will be at risk if SP1 becomes bankrupt because then the trustee can invoke s 20(1)(b), and the assignment will be ineffective. On the other hand, if SP2 does perfect, it can enforce the agreement, and this means it will be paid in full ahead of SP1's unsecured creditors.

The alternative possibility is that SP1's promise is simply a personal one; in other words, SP1's promise is to make a payment to SP2 when and if SP1 enforces its security interest against Debtor, but not to transfer SP1's claim. If this analysis is right, the PPSA does not apply, and there is nothing for SP2 to register. Assume that SP1 becomes bankrupt and the trustee refuses to honour the subordination agreement. SP2 will have a claim for damages against the trustee, which it will have to prove for in the bankruptcy proceedings. The end result is that it may get some sort of *pro rata* payment, but it will not be paid in full.

There is also no requirement to register a financing change statement to record the subordination; however, s 50 makes a financing change statement for this purpose permissible. The main reason for taking advantage of this option is in effect to publicize the subordination, that is, to put third parties on notice that SP2 has priority over SP1, and should conduct themselves accordingly, especially where there may be complex subordination arrangements in place.

B. POSTPONEMENT VS SUBORDINATION

Section 40(2) of the SPPSA starts with the words: "An agreement or undertaking *to postpone* or subordinate" (emphasis added). Is a postponement different from a subordination? The terms are often used interchangeably, but typically "subordination" refers to subordination of a security interest, while "postponement" refers to an agreement whereby the obligations owed by a debtor to one creditor are to be performed only once its obligations to another creditor have been performed (that is, postponed in time).

The distinction is reflected in clauses (a) and (b) of s 40(2) of the SPPSA:

> An agreement or undertaking to postpone or subordinate:
>
> (a) the right of a person to performance of all or any part of an obligation to the right of another person to the performance of all or any part of another obligation of the same debtor; or

(b) all or any part of the rights of a secured party pursuant to a security agreement to all or any part of the rights of another secured party pursuant to another security agreement with the same debtor;

does not, by virtue of the postponement or subordination alone, create a security interest.

Section 40(2)(a) refers to a postponement and s 40(2)(b) a subordination.

Postponement provisions are often found in subordination agreements, the intention being both to obtain a subordination of security and a postponement of debt obligations. For example, assume Susan, the sole shareholder of XYZ Inc, has given a secured loan to XYZ. The loaned money is, in effect, part of the capital of the corporation, and it may need the funds in order to function. A subsequent third party lender will likely require Susan to subordinate her security interest to that of the new lender (see the discussion in Section A above), but it will also want to control how Susan's loan can be repaid, to ensure XYZ's capital is not depleted. A postponement of debt may prohibit all debt payments, whether interest or principal, until the new creditor's debt has been repaid, or perhaps allow interest to be paid so long as XYZ remains financially sound, but not allow any principal to be repaid until the new lender is fully repaid, or any number of variations on these themes.

Postponements of debt may also be found in various other agreements, including guarantees, where the beneficiary of the guarantee not only wants the guarantee itself, but comfort that the guarantor will not require repayment of any amounts owing by the debtor (or even accept repayments) until the beneficiary of the guarantee has been fully repaid. Such clauses in a guarantee may often be combined with a turnover clause, providing that any amounts owing by the debtor to the guarantor are assigned to the beneficiary of the guarantee, and if nonetheless received, must be turned over. Depending on how it is drafted, such a clause may create a security interest and require registration. This can be a trap for the unwary.

C. SUBROGATION VS SUBORDINATION

While the two words subrogation and subordination sound similar, they mean very different things. Nonetheless, they are often addressed in the same agreement. Subrogation has been defined as:

> The substitution of one person in the place of another with reference to a lawful claim, demand or right, so that he who is substituted succeeds to the rights of the other in relation to the debt or claim, and its rights, remedies, or securities.[25]
>
> In *N'Amerix Logistix (Re)*, the Court, discussing subrogation in the context of the OPPSA, stated:
>
> Subrogation as an available remedy is explicitly recognized in s. 63(11) of the Ontario Act [i.e. the PPSA], and is implicitly recognized in s 72 of the Act preserving the general principles of common law. Subrogation is a broad and flexible remedy seemingly available, to prevent unjust enrichment, where a person makes payment to a creditor at the debtor's request or guarantees payment at the creditor's request, or where the payment is made to a creditor to protect the legitimate interest of the payor. *The latter species is certainly broad enough to confer subrogational rights on a junior secured party which pays off the senior secured party where the debtor is in default*.[26]

25 *N'Amerix Logistix Inc (Re),* 2001 CanLII 28082 at para 32, 57 OR (3d) 248 (Sup Ct J), quoting Black's Law Dictionary, as approved in *Midland Mortgage Corp v 784401 Ontario Ltd*, [1993] OJ No 2671 (QL) (Gen Div).

26 *N'Amerix Logistix Inc (Re)*, *ibid* at para 23, quoting Jacob S Ziegel & David L Denomme, *Ontario Personal Property Security Act: Commentary and Analysis,* 2nd ed (Markham, Ont: Butterworths, 2000) at para 30.8 (emphasis added).

Consider the following example.

Example 6

Debtor borrows $100 from SP1 and enters into a general security agreement in favour of SP1. SP1 properly registers. Debtor then enters into a loan agreement with SP2, also secured under a general security agreement, and SP2 properly registers. A condition of any advances under the SP2 credit agreement is that SP1 subordinate its position to SP2, and SP1 does so. SP2 then advances $100. Debtor becomes bankrupt, with total assets of $150. At the date of the bankruptcy, the debts owing to SP1 and SP2 both remain unpaid. The trustee recognizes that SP1 holds a first ranking perfected security interest in all Debtor's assets, and so it hands over $100 in assets to SP1. In accordance with the subordination agreement, SP1 turns these assets over to SP2. SP2 is now fully repaid, but SP1 has so far recovered nothing. Does it have any remedy?

On the basis of the passage quoted above, the doctrine of subrogation may apply, SP1 being "a junior creditor which pays off a senior creditor when the debtor is in default."[27] On that basis, the trustee would be required to hand over the remaining $50 assets in the estate to SP1. The justification is to prevent Debtor's unsecured creditors from being unjustly enriched at SP1's expense. SP1 held a perfected security interest in all Debtor's assets, and so the unsecured creditors could not have reasonably expected that they would be paid ahead of SP1. But without subrogation, that is exactly what would happen: the remaining $50 assets in the estate would go to the unsecured creditors, and SP1 would be left with nothing. The doctrine of subrogation prevents this outcome. Subordination agreements commonly contain a subrogation clause that provides expressly for the subordinating creditor's right of subrogation in a case like Example 6. The purpose is to avoid any uncertainty about whether the doctrine of subrogation applies.

Changing the facts of Example 6, assume now that SP2 was unperfected at the date of the bankruptcy. As before, the trustee makes $100 available to SP1, who turns it over to SP2, fully paying out SP2. But now, the remaining $50 is kept for distribution to the unsecured creditors. The reason is that SP2's security interest is unperfected, and so it is not effective as against the trustee (OPPSA, s 20(1)(b)). Subrogation is a derivative right, in the sense that it gives the beneficiary (SP1) no larger claim than the claim held by the original party (SP2). Since SP2's original claim is not effective against the trustee, SP1's subrogated claim is not effective against the trustee either. In this scenario, SP1 recovers nothing, except perhaps the small amount SP2 can claim as an unsecured creditor (to which SP1 is subrogated). How could SP1 have protected itself against this result? One approach would be to condition the subordination on the beneficiary's (SP2's) security interest being valid and perfected. SP2 would have to agree to this stipulation, but that would be a matter for negotiation between the parties.

D. ESTOPPEL LETTERS

As discussed in Chapter 5, Section III.B.3, in contrast to the other PPSA jurisdictions, a filing under the OPPSA may tell the searcher very little about the nature of the security interest being claimed by the secured party. For example, if the secured party selects "equipment" in the financing statement, the searcher will not know whether the secured party has a security interest in simply one item of equipment, or all equipment. In theory, the searcher could request further information under s 18, but what is to stop the secured party from later relying on its filing to claim a broader pool of collateral?

27 *Ibid*.

A common precaution against this risk is to obtain an estoppel letter (also called a "no interest" letter). An estoppel letter is a communication from one secured party (SP1) to another (SP2), whereby SP1 commits itself to certain statements about its security interest. Often in these letters, SP1 will identify the exact nature and extent of its collateral, commit not to rely on its registration for anything other than the collateral as identified, and acknowledge SP2's reliance on these assurances in proceeding with its transaction. The aim is to create an estoppel in SP2's favour that would prevent SP1 from claiming as against SP2 that its security interest extends beyond the limits specified in the letter. See the sample estoppel letter in Appendix B.

As discussed above in relation to Example 2, SP2 could, instead of requesting an estoppel letter, ask SP1 to amend its registration by adding a collateral description to narrow the scope of its collateral or, alternatively, to enter into a subordination agreement with SP2. However, for various reasons, SP1 will often refuse to do either. Can you identify some of these reasons?

On the other hand, there may be circumstances where SP1 is prepared to provide an estoppel letter, even if it is not prepared to amend its collateral description or negotiate a subordination agreement. Consider the following example.

Example 7

SP2 is planning to enter into a credit agreement with Debtor, secured under a general security agreement. SP2 wants to ensure that it has first priority, so it conducts a search against Debtor and finds an earlier filing by XYZ Leasing Ltd (SP1), which identifies the collateral as "equipment." Given the reference to "leasing" in SP1's name, SP2 can be reasonably confident that SP1's collateral is limited to equipment leased by SP1 to Debtor, and SP2 is not interested in the leased equipment. But it may not be safe for SP2 to proceed on this basis. For example, assume that SP1 later takes a security interest in Debtor's other equipment. Applying s 30(1), rule 1 in conjunction with s 45(4), SP1 would then have priority over SP2 in relation to the other equipment.

Given this risk, SP2 may ask SP1 for some comfort SP2 can rely on. SP1 knows this, as it regularly gets similar inquiries, and it has determined that the easiest and least expensive way to respond is with an estoppel letter. It has a standard form it can easily generate (and will not negotiate). It prefers providing letters to particular secured parties on a case-by-case basis rather than inserting a detailed collateral description in its filing that binds it as against the world and may prove too narrow in the future. Similarly, it prefers using a standard form estoppel letter to separately negotiating a subordination agreement every time it receives a request from someone like SP2.

IX. CIRCULAR PRIORITIES

Consider the following example.

Example 8

Day 1. SP1 gives Debtor a $200 secured loan. SP1 files.
Day 2. SP2 gives Debtor a $100 secured loan. SP2 files.
Day 3. SP3 gives Debtor a $150 secured loan. SP3 files.
Day 4. SP1 subordinates its security interest to SP3.
Day 5. Debtor becomes bankrupt with $225 in assets.

Who gets what amounts?

Applying OPPSA, s 30(1), rule 1, SP1 defeats SP2, and SP2 defeats SP3, but taking into account the subordination agreement, SP3 defeats SP1. So, we now have a circular priority problem. See the following case for a discussion of how this should be addressed.

Royal Bank of Canada v General Motors Acceptance Corporation of Canada Ltd

2006 NLCA 45

ROWE JA (Wells CJNL and Welsh JA concurring):

Facts

[1] At issue is priority among secured creditors of Hickman Equipment Limited (HEL) to the proceeds of sale ($884,500) from eight units of heavy equipment (three backhoes, three excavators and two loaders) that were owned by HEL.

[2] HEL is bankrupt. It had been in the business of selling or leasing heavy equipment, primarily for road construction and forestry.

[3] In large measure, the facts are not in dispute; rather, the dispute centres on the legal effect of a subordination agreement between the Appellant, Royal Bank of Canada (RBC), and Canadian Imperial Bank of Commerce (CIBC), and how (if at all) this affects priority as between RBC and the Respondent, General Motors Acceptance Corporation (GMAC), to the proceeds of sale of the eight units.

[4] RBC's "Concise Statement of Facts" was largely accepted by GMAC. Accordingly, I reproduce it below, noting an area of difference raised by GMAC.

> By a Receiving Order made on the 13th day of March, 2002, pursuant to the provisions of the *Bankruptcy and Insolvency Act* ("BIA") and filed with the Supreme Court of Newfoundland and Labrador in Bankruptcy on the 14th of March, 2002, Hickman Equipment (1985) Limited ("HEL") was adjudged bankrupt and Price WaterhouseCoopers Inc. ("PWC") was appointed Trustee of the bankrupt estate (the "Trustee"). By a further Order of the Court granted on the 13th of March, 2002, and filed with the Court on the 14th of March, 2002, it was ordered that PWC be appointed Receiver ("Receiver") of HEL (the "Receivership Order"). The Receivership Order gave PWC the overall mandate of developing a plan and procedural structure for the liquidation of the assets of HEL, as defined in paragraph 6 of the Receivership Order, and also a plan for the determination of the rights of all creditors and claimants. In that regard, a Claims Plan was approved by [the Trial Division] by an Order dated May 14, 2002, and filed May 17, 2002 (the "Claims Plan"). Paragraph 14 of the Claims Plan required the Trustee to issue a Final Determination either allowing a claim as a valid secured claim under s. 135(4) of the BIA, or disallowing it as a valid secured claim. Paragraph 15 of the Claims Plan provided that claims disallowed by the Trustee under this process were afforded a 30-day right of appeal under the BIA. The Trustee was not required under the Claims Plan to make findings as to the priorities between the security interests in the assets of HEL as claimed by competing secured creditors.
>
> Royal Bank of Canada ("RBC") presented its security interest claim to the Trustee and the Trustee issued its Final Determination of the RBC Claim and allowed the RBC Claim as a valid secured claim. Canadian Imperial Bank of Commerce ("CIBC") presented its security interest claim to the Trustee and the Trustee issued its Final Determination of the CIBC Claim and allowed the CIBC Claim in part as a valid secured claim. General Motors Acceptance Corporation ("GMAC") presented its security interest claim to the Trustee and the Trustee issued its Final Determination of the GMAC Claim and allowed the GMAC Claim as a valid secured claim.
>
> The Trustee, in the Final Determinations of the CIBC Claim, the GMAC Claim and the RBC Claim, made the following determinations, which were not been (sic) appealed to the [Trial Division]:

(a) The CIBC security interests in the RBC Collateral were created by two security agreements, namely:

(i) A Debenture dated January 7, [1985] and Supplemental Debentures dated February 19, 1990; April 17, 1997; August 7, 1997 and July 9, 1998 (collectively the "Debenture and Supplemental Debentures");

(ii) A General Security Agreement dated January 25, 2000 (the "GSA").

(b) The GMAC security interest in the RBC Collateral was created by a Security Agreement (Leasing) between GMAC and HEL dated July 25, 2000.

(c) The RBC security interest in the RBC Collateral was created by secured transactions between RBC and HEL in the form of equipment leases dated March 14, 2001, April 4, 2001 and May 3, 2001.

(d) The perfection dates for determining the priority of the CIBC security interest created by the Debenture and Supplemental Debentures are January 29, 1985 (the Debenture), February 22, 1990 (First Supplemental Debenture), April 30, 1997 (Second Supplemental Debenture) August 29, 1997 (Third Supplemental Debenture) and July 15, 1998 (Fourth Supplemental Debenture).

(e) The perfection date for determining the priority of the GMAC security interest is December 13, 1999.

(f) The perfection date for determining the priority of the CIBC security interest created by the GSA is January 25, 2000.

(g) The perfection dates for determining the priority of the RBC security interest are March 14, 2001; April 2, 2001; and May 3, 2001 depending on the particular RBC Collateral.

By Order of the [Trial Division] dated May 14, 2002, the Trustee commenced and completed liquidation of substantially all the assets of HEL by auction.

• • •

Paragraph 20 of the Claims Plan provided that the order of priority of claims to the proceeds arising from the sale of the assets of HEL be determined using the priority rules established by the *Personal Property Security Act*, S.N.L. 1998, c. P-7.1 (the "PPSA") and other applicable law. Paragraph 21 of the Claims Plan provided that issues of priority and entitlement to collateral between secured claimants may, upon application, be brought before [the Trial Division] for determination, pursuant to the provisions of s. 68 of the PPSA.

RBC applied to the Court pursuant to the Claims Plan and s. 68 of the PPSA for (i) a determination of the priority entitlement of RBC vis-à-vis other claimants, to the proceeds of the sale of the RBC Collateral, and (ii) an Order that the Trustee pay the proceeds from the sale thereof to RBC. Each of CIBC and GMAC filed an objection to the priority claim of RBC.

• • •

RBC claimed priority and entitlement to the proceeds arising from the sale of the [eight units] of the RBC Collateral ($884,500.00) by virtue of a specific subordination agreement between CIBC and RBC contained [in] letters dated April 3, 2001 and May 2, 2001 (the "Priority Agreements"). GMAC was not requested by RBC to execute similar priority agreements.

On the basis of the residual priority rules under s. 36 of the PPSA, the competing security interests in the RBC Collateral had the following priority rankings:

(a) The CIBC security interest created by the Debenture and Supplemental Debentures;

(b) The GMAC security interest;

(c) The CIBC security interest created by the GSA; and

(d) The RBC security interest.

[In its factum, GMAC stated that the foregoing priorities are not "facts," but rather are RBC's position; the foregoing priorities accord with the findings of fact of the Trial Judge … .]

• • •

In the [Trial Division], CIBC did not seek to enforce its security interests in [the eight units] of the RBC Collateral, and CIBC withdrew its objection to RBC's claim to the proceeds arising from the sale of [the eight units]. In the decision appealed from, the [Trial Division] granted GMAC priority over RBC to the proceeds arising from the sale of [the eight units] of the RBC Collateral. …

• • •

Issues

[7] It is not in issue that CIBC subordinated its security interests in the eight units to RBC's security interest in them. Rather, what is in issue is whether by virtue of that subordination: (a) RBC moves up to stand in the place of CIBC and thereby gains priority over GMAC; or (b) while CIBC ranks in priority behind RBC, nonetheless GMAC retains its priority over RBC.

• • •

Analysis

• • •

[15] RBC's security interests were perfected in March, April and May, 2001. In April, 2001 and May, 2001, CIBC subordinated its security interests in the eight units to RBC's. What impact, if any, does that have on the priority of RBC's and GMAC's security interests? RBC says the subordination agreements with CIBC have the effect of giving RBC the priority that CIBC has, i.e. ahead of GMAC. GMAC denies this and says that while the subordination agreements may govern priority as between CIBC and RBC, they do not affect GMAC's security interest, which has priority over RBC's (having been perfected before RBC's).

[16] The issue thus crystallizes into whether or not the CIBC-RBC subordination agreements have the effect of advancing RBC's priority to the rank of CIBC's, thus gaining priority over GMAC's. If they have this effect, RBC ranks ahead of GMAC; if not, GMAC ranks ahead of RBC.

[17] The analysis that follows must be considered in light of s. 41 of the PPSA:

> 41(1) A secured party may subordinate, in a security agreement or otherwise, the secured party's security interest to any other interest.
>
> (2) A subordination is effective according to its terms between the parties and may be enforced by a third party if the third party is the person or one of the class of persons for whose benefit the subordination was intended.

[18] At para. 22-23 of his Factum, counsel for RBC sets out the central proposition in his case:

> A subordination does not extinguish the subordinated creditor's security interest in the collateral [here, CIBC's security interest]. The subordinated security interest continues to have full force and effect. The benefiting creditor [here, RBC] obtains the benefit of the subordinated security interest and acquires priority over the subordinated creditor [here, CIBC] and any intervening creditor [here, GMAC] over

whom the subordinated creditor has priority by virtue of the subordinated security interest. In this regard, a subordination is used to change the effect of the residual priority rules that would otherwise prevail under the PPSA. …

Where a subordination is enforced by the benefiting creditor [RBC] for its benefit, the amount secured by the subordinated security interest simply goes toward satisfying in whole or in part two claims as opposed to one: the benefiting creditor's claim [RBC's] and the subordinated creditor's claim [CIBC's]. The benefiting creditor shall receive payment in full of its claim, before the subordinated creditor receives any payment on the subordinated debt. Where there is an intervening security interest [GMAC], the result is equitable, because the intervening creditor will receive what it expected to receive, the fund less the amount secured by the higher ranking subordinated security interest. Otherwise, the intervening creditor receives a windfall and the statutory rights bestowed on the subordinating creditor to subordinate its security interest and the benefiting creditor to enforce the subordination for its benefit are thwarted.

[19] If RBC can show the foregoing is sound in law, then as outlined above RBC will gain priority over GMAC by virtue of RBC's subordination agreements with CIBC.

[20] In his Factum (at para. 24), counsel for RBC sets out the authorities upon which he relies. I reproduce portions that relate to Canadian cases and texts … :

R.C. Cuming and R.J. Wood, *Alberta Personal Property Security Act Handbook*, [4th ed. (Toronto: Carswell, 1995)], pages 381-382:

A situation may arise where an intervening security interest ranks between the security interest of the subordinating creditor and the claim of the party in favour of whom the subordination is made. This is displayed in the following scenario:

A debtor (D) grants a security interest to SP1 covering all of D's present and after-acquired personal property. The security agreement secures $200,000. D grants a security interest in all present and after-acquired personal property to SP2 to secure a loan in the sum of $100,000. D then grants SP3 a security interest in all present and after-acquired personal property to secure an advance of $150,000. SP1 and SP3 enter into a subordination agreement under which SP1 agrees to postpone his claim until SP3's claim is fully satisfied. The collateral is sold and $225,000 is realized. The proceeds of realization are insufficient to satisfy all the secured claimants.

The priority competition is resolved as follows:

The amount of SP1's claim ($200,000) would be set aside and SP3's claim would be satisfied out of this fund. The remainder ($50,000) would be allocated to SP1. SP2's claim would then be satisfied out of the remainder of the fund ($25,000). The ultimate distribution therefore would be SP1: $50,000; SP2: $25,000; SP3: $150,000. In essence, the ranking of the claims and distribution of proceeds is determined apart from the operation of the subordination agreement. The subordination agreement is then applied to permit SP3 to satisfy her claim out of SP1's share of the proceeds.

Rico Enterprises Ltd. (Re), [1994] BCJ No. 414 (BCSC), at [paras. 36-37]:

… If one creditor subordinates its claim to the claim of another party without subordinating to other claims ranking in priority to the claim of the other party, it is my view that a distribution of the assets of the bankrupt debtor should be made as if there was no subordination except to the extent that the share of the distribution to which the subordinating creditor would otherwise be entitled should be paid to the party in whose favour the subordination was granted ...

It is not appropriate to simply take the subordinating creditor out of the class to which it belongs and put it in the class ranking immediately behind the holder of the subordination right. I say this for two reasons. First, the creditors in the same class as the subordinating creditor should not receive the benefit of a subordination agreement to which they are not a party and on which they are not entitled to rely. They would receive a windfall benefit by the removal of the subordinating creditor from their class in the event that there were insufficient monies to fully pay their class because the total indebtedness of the class would be reduced and the *pro rata* distribution would be increased. Second, if the parties to the subordination agreement turned their minds to it, they would inevitably agree that the subordinating creditor should receive its normal share of the distribution and give it to the party in whose favour the subordination was granted. The party receiving the subordination would agree because it would be paid a portion of a distribution to a higher class of creditor that it would not otherwise receive and the subordinating creditor would agree because it would not receive the money in either event.

Bank of Montreal v. Dynex Petroleum Ltd., [1997] A.J. No. 341 QL Systems (Albt. C.Q.B.) [per Rooke J.] at [paras. 86 and 88]:

An apparent circularity problem does arise, in that the trustee in bankruptcy has priority over the unregistered interest of Odessa and Meridian; Odessa and Meridian have priority over the [B of M] by virtue of the [B of M's] subordination; and the [B of M] has priority over the trustee in bankruptcy by virtue of its security. However, the solution to the apparent circularity has long been recognized in similar situations occurring in bankruptcy proceedings.

• • •

The concept of the subordinated creditor holding in trust the accounting to the senior creditor was also discussed by [R.M.] Goode, [*Legal Problems of Credit and Security*, 2d. (London: Sweet & Maxwell, 1988)] at 23-24, where he said:

> ... if the subordinated creditor enforces his security he holds what he receives on trust for the senior creditor up to the amount due to the latter or any lower sum fixed by the subordination agreement—but that in other respects each of the two [interest holders] retains exactly the same interest as he held before. ...

Grove Packaging Inc. (Re), [2001] O.J. No. 5502 (Ont. S.C.J.), at [para. 4]:

It appears to me that the reasoning of Rooke J in *Bank of Montreal v. Dynex Petroleum Ltd.* (1997), 46 CBR (3d) 36 (Alta. Q.B.) satisfactorily deals with the apparent circularity. ... While it is true that this decision was overturned by the Court of Appeal 1999 ABCA 363 (CanLII), (1999), 15 CBR (4th) 5 (Alta. CA), that appeal decision ... did not deal or comment upon the bankruptcy issue [i.e. that referred to above].

[21] I reproduce the American text on which counsel for RBC relies only because I read it as being consistent with Canadian authorities set out above and because of its exceptional clarity.

Grant Gilmore, *Security Interests and Personal Property*, Vol. II (Boston: Little, Brown and Company, 1965) at:
At p. 1020:

> §39.1 Types of circularities. What should be done when an inadequate fund is to be distributed among competing claimants and under applicable rules of law A is entitled to priority over B, who is entitled to priority over C, who is entitled to priority over A?

At p. 1021:

• • •

> The simplest of the three situations, which may be dismissed as not involving a "true circularity," arises from a contractual subordination or waiver. To start with, A, B and C have claims against debtor X or his property which are entitled to priority in alphabetical order: the classical example is that of first, second and third mortgages on Blackacre. A subordinates his claim to C's. Blackacre is sold and the resulting fund is insufficient to satisfy all three claims. There is a comforting unanimity, among courts and commentators, on the proper distribution of the fund.
>
> 1. Set aside from the fund the amount of A's claim.
> 2. Pay the amount so set aside to:
>   (a) C, to the amount of his claim;
>   (b) A, to the extent of any balance remaining after C's claim is satisfied.
> 3. Pay to B the amount of the fund remaining after A's claim has been set aside.
> 4 If any balance remains in the fund after A's claim has been set aside and B's claim has been satisfied, distribute the balance to
>   (a) C,
>   (b) A.

Thus C, by virtue of the subordination agreement, is paid first, but only to the amount of A's claim, to which B was in any event junior. B receives what he had expected to receive [from] the fund less A's prior claim. If A's claim is smaller than C's, C will collect the balance of his claim, in his own right, only after B has been paid in full. A, the subordinator, receives nothing until B and C have been paid except to the extent that his claim, entitled to first priority, exceeds the amount of C's claim, which, under his agreement, is to be first paid.
At p. 1032:

> §39.3 Circularity litigation since 1940. … The most popular solution has been to apply the rule used in cases of apparent circularity resulting from a subordination agreement. In the subordination case A, B and C have liens which rank in that order; A then subordinates his claim to C's. The solution is to set aside from the fund the amount of A's claim; pay that to C and the balance, if any, going to A and B in that order. In a true subordination case, it is assumed that there is no difficulty in establishing the normal order of priority which would have settled the distribution (A first, then B, then C) except for A's subordination to C.

[22] While U.S. and English authorities cited by RBC also support its position, I omit them and place reliance only on Canadian authorities.

• • •

[25] The argument set out for RBC is persuasive. I adopt the above reasoning, notably as set out in the excerpts from R.C. Cuming and R.J. Wood, Alberta Personal Property Security Act Handbook, *supra*, and Grant Gilmore, Security Interests and

Personal Property, *supra*. Accordingly, I would allow the appeal and give judgment in favour of RBC.

NOTES

1. The approach approved of in the *GMAC* case provides an easy to follow and conceptually attractive solution in the subordination context. SP2 gets what it always expected to get given its subordinate position to SP1, and the rest is settled based on the terms of the agreement between SP1 and SP3. However, what if the subordination agreement itself, properly understood, requires a different approach? As discussed in the following note, the correct answer turns on what the parties actually agreed to.

2. In *CIF Furniture Limited (Re)*,[28] the Ontario Court of Appeal considered a priorities dispute between three secured creditors (V, K, and C) of an insolvent corporation (CIF). As a result of the order of filings and various subordination agreements, the Court faced a situation where:

- K filed first, but agreed with V that V (owed $4.35 million) ranked ahead of K (owed $1 million).
- K ($1 million) ranked ahead of C.
- V filed ahead of C, but agreed that C would rank ahead of V.

The Court considered whether V agreed to what it called a "complete subordination" under which V agreed not to assert any claim at all against CIF's assets until C's claim was satisfied, or a "partial subordination," which in effect is the approach approved of in the *GMAC* case. According to the Court:

> If the theory of complete subordination is applied, the priorities are:
>
> - first, K;
> - second, C;
> - third, V.[29]

The Court concluded that the right answer here was to apply the partial subordination approach, but again reached that conclusion based on an analysis of what the subordination agreement in question provided for:

> Whether complete or partial subordination should be applied turns on [V's] intention, as disclosed by the various agreements. Do the agreements show that [V] intended to wholly step aside and go to the bottom of the queue, or do they show that [V] intended to step aside only to the extent of [C's] interest?[30]

The Court concluded that

> to give effect to [K's] position [complete subordination], one would have to infer that VenGrowth intended to go to the bottom of the queue. To draw that inference, one would expect some clear and unequivocal language in one of the documents, or at the very least, an exchange of correspondence between [V] and [K]. Nothing of that sort exists.[31]

The *GMAC* case and the *CIF* case both address circular priority problems in the context of subordination agreements, but subordination agreements are not the only source of circular priority problems. For example, the problem can also surface where OPPSA, s 30(6) applies: see Section VII above. Consider the following modified version of Cuming & Wood's example, discussed in the *GMAC* case.

28 2011 ONCA 34.
29 *Ibid* at para 20.
30 *Ibid* at para 25.
31 *Ibid* at para 38.

> Example 9
>
> Debtor grants SP1 [A] a security interest covering all of Debtor's present and after-acquired personal property. The security agreement secures a loan of $200,000. Debtor grants SP2 [B] a security interest in all present and after-acquired personal property to secure a loan in the sum of $100,000, and SP2 [B] registers a financing statement. SP1's [A's] security interest is perfected by registration at the time of Debtor's contract with SP2 [B], but it subsequently becomes unperfected. While SP1's [A's] security interest is unperfected, Debtor grants SP3 [C] a security interest in all present and after-acquired personal property to secure an advance of $150,000, and SP3 [C] registers a financing statement. SP1 [A] subsequently reperfects its security interest. Ultimately the collateral is sold, and $225,000 is realized. The proceeds of realization are insufficient to satisfy all secured claimants.

SP1 [A] has priority over SP2 [B] under the first part of the rule in s 30(6), regardless of when SP1 [A] reperfects; SP2 [B] has priority over SP3 [C] under s 30(1), rule 1; and SP3 [C] has priority over SP1 [A] under the second part of the rule in s 30(6). What solution should the court use for the circular priorities problem in this case? In the United States, the most popular solution for circular priority problems arising other than in the context of subordination agreements

> has been to apply the rule used in cases of apparent circularity resulting from a subordination agreement. In the subordination case, A, B and C have liens which rank in that order; A then subordinates his claim to C's. The solution is to set aside from the fund the amount of A's claim; pay that to C and the balance, if any, going to A and B in that order.[32]

The Court in the *GMAC* case quoted this passage (at para 21) with approval, and so the case is at least persuasive authority for the conclusion that the same solution applies in Canada.[33]

X. THE DOUBLE DEBTOR ISSUE

Jacob S Ziegel, David L Denomme & Anthony Duggan, Ontario Personal Property Security Act: Commentary and Analysis, 3rd ed

(Toronto: LexisNexis, 2020) at 273-75 (footnotes omitted)

The double debtor problem arises where collateral is transferred by the debtor to another party, with or without the secured party's consent. The following example illustrates the problem.

> *Example [1]*
>
> D1 gives a security interest in equipment to SP1. SP1 registers a financing statement against D1's name on Day 10. On Day 30, D1 sells its business, including all its equipment, to D2 and notifies SP1 of the sale. On Day 40, D2 gives SP2 a security interest in all its present and after-acquired personal property and SP2

32 Grant Gilmore, *Security Interests in Personal Property* (Boston: Little, Brown & Co, 1965) at 1032.

33 For a fuller discussion of circular priorities systems in the secured transactions context, see Roderick J Wood, "Circular Priorities in Secured Transactions Law" (2010) 47 Alta L Rev 823.

registers a financing statement on the same day. In a dispute between SP1 and SP2 over the equipment, who has priority?

The issue Example [1] raises is whether the priority rules in OPPSA, sub-s.30(1) apply where the competing security interests are given by different debtors. The starting point is sub-ss 48(1) and (2) which provide that in cases like Example [1], SP1 must register a financing change statement within a defined grace period, substituting D2 as the new debtor, otherwise its security interest becomes unperfected. The grace period varies depending on whether the transfer took place with SP1's consent and, if not, whether SP1 had prior knowledge of the transfer. The provisions presuppose that SP1's security interest survives the D1-D2 transfer, in other words that D2 holds the disputed equipment subject to SP2's security interest, and their purpose is to facilitate register searches. If SP1 does not amend its registration, a party dealing with D2 is likely to search against D2's name, but since SP1's security interest is registered against D1's name, the search will not disclose SP1's security interest ... .

Assuming that, in Example [1], SP1 registers a financing statement within the s.48(1) or (2) grace period, its security interest remains perfected and it is in competition with SP2's perfected security interest. According to one school of thought, the priority rules in s.30(1) only apply where the competing security interests are given by the same debtor; the statute contains no priority rule for cases where the security interests are given by different debtors; and so the common law *nemo dat* rule applies. In Example [1], SP1 would have priority under the *nemo dat* rule: D1 holds the disputed equipment subject to SP1's security interest, D2 holds the equipment subject to the same limitation and the security interest D2 gives SP2 is correspondingly bounded. The contrary viewpoint is that the priority rules in s.30(1) do apply and, since SP1 registered first, SP1 has priority. In summary, on the facts of Example [1], both approaches lead to the same outcome. But the outcomes diverge in cases like Example [2].

Example [2].

D1 gives a security interest in equipment to SP1. SP1 registers a financing statement against D1's name on Day 10. SP2 agrees to give a line of credit to D2 and files a financing statement showing D2 as the debtor on Day 5. On Day 30, D1 sells its business, including all its equipment, to D2 and notifies SP1 of the sale. SP1 registers a financing change statement within the sub-s.48(1) or (2) grace period.

On these facts, if s.30(1) applies, SP2 has priority because it was the first to register, but if the *nemo dat* rule applies, SP1 has priority. The better view is that the s.30 priority rules do apply where the competing security interests are given by different debtors. Sections 48(1) and (2) are clearly drafted on this assumption and the provisions would be redundant if the *nemo dat* rule applied instead. *Lisec America Inc. v. Barber Suffolk Ltd*, a case involving a double debtor dispute, impliedly supports this view. There, Lisec (SP1) registered a financing change statement after discovering the collateral transfer between the two debtors (D1 and D2); the court held that, as a result, Lisec's security interest remained perfected; and since Lisec registered before the competing secured party (SP2), it had priority. There was no reference in the case to the *nemo dat* rule and the court simply assumed that, once Lisec's perfected status under s.48 had been determined, the statutory priority rules applied.

The problem with this approach is in its application to Example [2], above, where it leads to SP2 having priority because it was the first to register. This outcome is intuitively unappealing. SP1 complied with the statute by registering a financing change statement within the s.48 grace period and, given, the chronology, there is little SP1 could have done to protect itself other than by regularly monitoring the collateral in D1's hands. On the other hand, SP2 could have taken precautions. Its security interest secured a line of credit in D2's favour and so it might not be unreasonable to expect SP2 to investigate the source of any second-hand collateral before making an advance against it under the line of credit. In all the other PPSA jurisdictions, there is a provision aimed specifically at this situation and it provides that, as a general rule, in cases like Example [2], SP1 has priority [see e.g. Saskatchewan PPSA, s 35(8)].

In the absence of a corresponding provision in the OPPSA, it is unclear how an Ontario court might approach a case like Example [2]. If the court applies the *nemo dat* rule…, it would have to consider whether the same rule should also apply in Example [1]. If the court decides that the *nemo dat* rule should apply in both cases, it would have to reconcile its conclusion with s.48, which clearly implies the opposite. The court would face a similar challenge if it were to decide that the *nemo dat* rule applies in Example [2], but not Example [1]. And if the court were to decide that the s.30 priority rules apply in both cases, that would mean having to live with the unsatisfactory priority outcome that s.30 produces in cases like Example [2].

Problem 6.1

Day 1. In anticipation of completing a loan transaction with Debtor, SP1 registers a financing statement, even though the transaction has not been completed and Debtor has not yet executed any documents.
Day 10. SP2 makes an advance to Debtor, and Debtor signs a general security agreement in favour of SP2. SP2 registers a financing statement against Debtor.
Day 15. SP1 makes an advance to Debtor, and Debtor signs a general security agreement in favour of SP1.
Day 50. Debtor defaults and both SP1 and SP2 claim Debtor's printing press, being its only asset which it had owned since Day 1.

Who has priority?

Problem 6.2

Day 1. SP1 lends $100 to Debtor on the security of a gold bar pursuant to a written security agreement. SP1 takes possession of the gold bar.
Day 10. SP2 makes an advance to Debtor, and Debtor signs a general security agreement in favour of SP2. SP2 files against Debtor.
Day 15. SP1 files against Debtor and then returns the gold bar to Debtor.

As between SP1 and SP2, who has priority to the gold bar?

Problem 6.3

Debtor (D) is a car dealer and has both a "Finest Auto" dealership, selling Finest brand cars, and a "Best SUV Car" dealership, selling Best SUV brand cars, each in different locations.
Day 1. D enters into a wholesale floor plan financing arrangement with Finest Auto Finance (FAF) to finance D's acquisition of inventory, including a security agreement charging all of D's present and after-acquired Finest cars. FAF files under the OPPSA, marking the "inventory" collateral classification box and including a general collateral description that states, "All present and after-acquired Finest cars."

Day 10. D enters into an inventory finance agreement with Bank to finance D's acquisition of Best SUV cars, secured under a general security agreement. Bank files under the OPPSA, but before advancing any loans, conducts an OPPSA search and sees the FAF filing. Given the general collateral description, Bank is not concerned as it is not planning to finance Finest cars, so it proceeds to make its advances.
Day 100. FAF conducts a regular audit of its loans and security. To its shock, it discovers that it had accidentally financed D's acquisition of a Best SUV car (the New SUV), and since its security agreement only charges Finest cars, it does not have a security interest in this car. FAF threatens to call its loan. D offers to provide FAF with security on the New SUV. FAF agrees to accept the new security agreement and calls its lawyer to prepare the documentation, but the lawyer is away on vacation. FAF does not want to wait for its lawyer to return, so FAF asks D to agree verbally to give FAF a security interest in the New SUV (with the thought that FAF will get a written security agreement in due course). D agrees.
Day 150. FAF realizes D's situation is getting even worse, and so it repossesses the New SUV.
Day 200. D declares bankruptcy. Its only assets at this point are two cars: the New SUV and a used Mercedes car that is still on D's lot. Both FAF and Bank claim the two cars.

Who wins as to each car?

Problem 6.4

Day 1. SP1 enters into a security agreement with Debtor and registers for one year, thereby perfecting its security interest.
Day 366. SP1 forgets to renew its registration and therefore becomes unperfected.
Day 400. SP2 and Debtor are getting ready to close a secured loan deal. In anticipation of closing, SP2 registers a financing statement. It then searches and, finding no other filings, it proceeds with the secured loan deal.
Day 405. SP1 hears about SP2's deal closing, so contacts you as its lawyer to get advice on what to do.

What do you advise SP1 to do?

Problem 6.5

Day 1. SP1 enters into a security agreement with Debtor and registers for one year, thereby perfecting its security interest.
Day 366. SP1 forgets to renew and therefore becomes unperfected.
Day 400. SP2 and Debtor are getting ready to close a secured loan deal. In anticipation of closing, SP2 registers a financing statement. It then searches but finds no other filings.
Day 401. SP2's deal has still not closed, but in the meantime, SP1 files against Debtor to reperfect its earlier registration that had lapsed.
Day 403. SP2 and Debtor close their deal. Debtor signs and delivers a security agreement and SP2 makes the advance.
Day 410. SP1 hears about SP2's deal closing, so contacts you as its lawyer to get advice on what to do.

What do you advise SP1 to do?

Problem 6.6

Day 1. SP1 lends $100 to Debtor on the security of a gold bar pursuant to a written security agreement. SP1 files against Debtor for one year, thereby perfecting its security interest.
Day 300. SP1 becomes concerned about Debtor's solvency and insists on taking possession of the gold bar to better protect its security interest.
Day 366. SP1 does not renew its filing as it has possession and so is not concerned about registration.

Day 380. SP2 establishes a new secured credit facility in Debtor's favour secured against all Debtor's present and after-acquired personal property. SP2 registers.
Day 400. Debtor tells SP1 it has a buyer for the gold bar, so asks for its return. SP1 is keen to see Debtor realize some money from the gold bar and returns it to Debtor so Debtor can sell it.
Day 405. The sale falls through. SP1, though, is still hopeful that Debtor can revive the proposed sale so leaves the bar with Debtor.
Day 415. SP1 refiles.

In a contest between SP1 and SP2, who wins?

Problem 6.7

Day 1. SP1 lends $100 to Debtor on the security of a gold bar pursuant to a written security agreement. SP1 files for one year.
Day 366. SP1 fails to renew its registration and so becomes unperfected.
Day 370. SP2 makes an advance to Debtor, and Debtor signs a general security agreement in favour of SP2. SP2 fails to file.
Day 380. SP1 refiles.

As between SP1 and SP2, who has priority to the gold bar?