Court File No. CV-14-10766-00CL

ONTARIO
SUPERIOR COURT OF JUSTICE
(COMMERCIAL LIST)

B E T W E E N:

TRISURA GUARANTEE INSURANCE COMPANY

Applicant

- and -

EBERSOLE EXCAVATING INC. AND D&S RAILWAY CONSTRUCTION INC.

Respondents

RESPONDING FACTUM OF TRISURA GUARANTEE INSURANCE COMPANY

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INDEX

1

Citation: Bank of Nova Scotia v IPS Invoice Payment System Corporations, 2010 ONSC 2101
Court File No.: 09-8439-CL
Date: 20100409

SUPERIOR COURT OF JUSTICE - ONTARIO

RE: Bank of Nova Scotia, Applicant

AND:

IPS Invoice Payment System Corporations and Integrated Business Concepts Inc., Respondents

BEFORE: Madam Justice Karakatsanis

COUNSEL: Doug Bourassa, Counsel, for the Applicant

Christopher Sparling, Counsel, for the Respondent, IPS

Gerald Matlofsky, Counsel, for the Respondent, IBC

HEARD: March 15, 2010

ENDORSEMENT

[1] The Bank of Nova Scotia seeks a declaration that the proceeds collected by each of the respondents from accounts receivable of 1429030 Ontario Inc (Blooming Rose) are subject to the Bank's prior ranking security interest in Blooming Rose's receivables. The respondents collected proceeds from the receivables directly from Blooming Rose's customers. The Bank seeks judgment against IPS Invoice Payment System Corporations (IPS) in the amount of $442,698.01 and US$33,193.95; and against Integrated Business Concepts Inc. (IBC) in the amount of $216,033.02 up to a total amount of Blooming Rose's indebtedness to the Bank of $442,698.01 and US$33,193.95 (plus interest and costs).

[2] The legal issue in this application is the interpretation of s. 25 of the *Personal Property Security Act,* R.S.O. 1990 c. P.10 (the "PPSA"): whether a secured party can enforce its security against both the original collateral and the proceeds of that collateral in an amount that exceeds the value of the original collateral. Put differently, the issue is whether the amount secured by the security interest in both the collateral and the proceeds is limited to the amount of the secured debt or the value of the collateral. This issue has not been addressed by any court in Ontario.

[3] The factual issues in this application are whether the undisputed facts give rise to an inference that the Bank acquiesced or waived its rights.

Background Facts

[4] The following facts are uncontroverted. Pursuant to a commitment letter in August 2008, the Bank extended credit facilities to Blooming Rose, including a revolving line of credit, margined against inventory and accounts receivable and secured by a prior general security agreement (GSA) dated February 2007. The Bank perfected its security interest in the property and assets, including the accounts receivables, of Blooming Rose pursuant to the PPSA by registering a financing statement in March 2007. The GSA provides that all amounts received by Blooming Rose from account debtors are to be held in trust for the Bank.

The factoring arrangement with IPS

[5] In September 2007, Blooming Rose signed a factoring agreement with IPS. Blooming Rose absolutely assigned each invoice to IPS, with no right of redemption. Pursuant to the factoring agreement Blooming Rose agreed to repurchase any account which IPS was unable to collect (recourse obligation) and granted to IPS a security interest in all accounts receivable (whether purchased or not purchased) to secure the repayment of the recourse obligations.

[6] IPS registered a financing statement perfecting its security interest in Blooming Rose's accounts receivables in September 2007, subsequent to the Bank's registration. IPS concedes it was aware of the Bank's security interest from the outset of its relationship as a result of its PPSA search and Blooming Rose's disclosure that its accounts receivable were pledged as collateral to the Bank.

[7] IPS advanced monies during the period between September 2007 and December 2008 in return for the absolute assignment of the receivables. Cheques totalling \$1.7 million were deposited to Blooming Rose's account with the BNS (in reduction of the indebtedness to BNS) with the name of "IPS Invoice Payment System Corp" evident as the payor. IPS advanced approximately \$100,000 more than IPS collected on the accounts receivables.

[8] The Bank claims that it first learned that Blooming Rose was factoring its accounts receivable with IPS in January 2009 at an account meeting with Blooming Rose. The Bank issued a notice of default, sought payment and ultimately the appointment of an interim receiver. The Bank seeks recovery of the amounts collected by IPS from customers to the full amount of the outstanding indebtedness of Blooming Rose.

[9] IPS does not dispute that the factoring agreement is subject to the PPSA or the prior registration of the Bank's GSA. However, it claims that as a purchaser of the accounts, pursuant to s. 25 of the PPSA, the proceeds from the sale of collateral were the amounts paid by IPS to Blooming Rose for the purchase of those accounts and that those proceeds were paid to BNS to reduce its indebtedness. IPS submits that the Bank would be receiving double recovery if it was entitled to claim security in both the proceeds of the sale of the collateral, as well as the further proceeds from the collections from the collateral. IPS takes the position that the factoring agreement was not prohibited by the Bank's GSA or by the PPSA but that, in any event, IPS advanced \$100,000 more than it collected and therefore BNS' security interest was not prejudiced under s. 39 of the PPSA.

Seasonal bridge financing by IBC for specific inventory

[10] Blooming Rose required financing on a seasonal basis to fund the cost of inventory leading up to its busy December sales. In 2006 and 2007 it obtained seasonal bridge financing from IBC. Between July and November 2008, IBC advanced a total of $380,000 to Blooming Rose in four separate cheques on condition that the funds be used to produce specific inventory for sale to Wal-Mart and Zellers and that it be repaid directly by the customer. IBC regularly monitored production of the inventory. At Blooming Rose's direction, Wal-Mart subsequently paid $216,033.02 directly to IBC in payment for the inventory.

[11] IBC was not aware of the Bank's GSA or of IPS' security interest in receivables, did not conduct a PPSA search and did not register its interest in the specific inventory pursuant to the PPSA. It obtained personal guarantees and other security for its loan.

[12] The Bank seeks recovery of the amounts received directly from Wal-Mart provided the Bank does not recover more than the outstanding debt secured by the GSA. IBC takes the position that BNS granted an implied license to Blooming Rose to deal with the inventory in the ordinary course of business and as a result, such a licence authorizes the "satisfaction of obligations that are immediately incidental to an actual sale of the inventory" to third parties: *Royal Bank of Canada v Sparrow Electric Corp.*, [1997] 1 S.C.R. 411. IBC submits that because its transaction with Blooming Rose was tied to specific inventory, the Bank's security interest gives way to debts incurred in the ordinary course of business. Further it submits that the Bank had effective notice and knowledge of the relationship and acquiesced or waived its rights and that IBC acted to its detriment in advancing further funds after its first advance.

IPS: Were the receivables collected by IPS encumbered by BNS's prior ranking security interest?

The factoring agreement is subject to the PPSA

[13] IPS does not dispute that the factoring agreement is subject to the PPSA or the prior registration of the Bank's GSA. Section 2(b) of the PPSA provides that the Act applies to every transaction that in substance creates a security interest including a transfer of an account even though the transfer may not secure payment or performance of an obligation. "Security interest" is defined in s. 1(1) of the PPSA as an interest in personal property which includes the interest of a transferee of an account. Section 39 of the Act provides that rights of a debtor may be transferred despite a provision in the security agreement prohibiting transfer or declaring a transfer to be a default, but no transfer may prejudice the rights of the secured party under the security agreement. Factoring arrangements and the assignment of accounts receivable are subject to the PPSA. See *Fairbanx Corp. v. Royal Bank,* [2009] O.J. 4222 (S.C.J.); also *2811472 Canada Inc.* (c.o.b. *Acorn Partners) v Royal Bank of Canada,* [2006] O.J. No. 2790 (S.C.J.) aff'd [2007] O.J.No. 820 (C.A.). Section 30(1) provides that priority is determined by the order of registration. There is no dispute that the Bank's registered GSA takes priority over IPS' registered security agreement.

The Bank did not authorize the factoring agreement

[14] I do not find that the Bank expressly or impliedly authorized the factoring agreement and thus the dealing with the collateral by Blooming Rose. IPS submits that the factoring agreement

was not prohibited by the Bank's GSA or by the PPSA. However, the GSA provides that Blooming Rose is to defend title and keep the collateral free and clear of encumbrances; all amounts received by Blooming Rose from account debtors are to be held in trust for the Bank; default occurs when any collateral is or is about to be in danger of being placed in jeopardy. Further, s. 39 does not authorize the transfer of collateral. It has no bearing on the issue of whether the transfer was lawful; it provides some protection to the transferee in the event of an unauthorized transfer of the collateral.

There can be more than one set of proceeds as defined by s. 25 of the PPSA

[15] Section 25 (1) provides:

> Where collateral gives rise to proceeds, the security interest therein,
>
> (a) continues as to the collateral, unless the secured party expressly or impliedly authorized the dealing with the collateral free of the secured interest; and
>
> (b) extends to the proceeds.

[16] Proceeds is defined in the PPSA as:

> identifiable or traceable personal property in any form derived directly or indirectly from any dealing with collateral or the proceeds therefrom, and includes
>
> ...
>
> (c) Any payment made in total or partial discharge or redemption of an intangible, chattel paper, an instrument or investment property....

[17] IPS submits that the proceeds in this case are the monies paid by IPS to Blooming Rose for the purchase of the accounts receivable and paid to the Bank to reduce the indebtedness to the Bank. The Bank takes the position that proceeds are the collection on factored receivables from the customers. I accept both propositions.

[18] I find that the monies paid by IPS to Blooming Rose for the purchase of the accounts receivable are proceeds within the definition in s. 1 and for the purpose of s. 25 of the PPSA. This is consistent with both the language and spirit of the legislation and with the decision of the New Brunswick Court of Queen's Bench in *Royal Bank v. Canadian Commercial Corp.*, 2001 CaswellNB 387 at para. 68. The court identified the amount paid by the factor to the debtor for the assignment of the accounts receivable as the proceeds of the sale of the collateral. However, the case provides little assistance on the issue of whether the security interest also extended to the receivables because the court also found that the bank had authorized the factoring of the receivables.

[19] I also find that the security interest extends to the further proceeds collected by the factor on those assigned receivables. In *Acorn Partners,* (S.C.J.) at paras. 25, 28; (C.A.) at para. 2, the court accepted that monies collected on factored receivables from the customers are proceeds within the meaning of the Act. In that case, the debtor had misled the factor advising that the accounts had not been pledged; in this case IPS was aware of the Bank's prior security interest.

While it was not clear in *Acorn Partners* what happened to the proceeds paid by the factor to the debtor pursuant to the factoring agreement, in this case the funds advanced to Blooming Rose were paid to the Bank in reduction of the indebtedness.

[20] Collateral can give rise to more than one set of proceeds. There is no reason to limit recovery to the proceeds under the factoring agreement in light of the clear language of s. 25. The definition of proceeds in the PPSA is sufficiently broad to cover both the monies paid by the factor to the debtor Blooming Rose for the absolute assignment of the receivables and the monies collected by the factor from the customers pursuant to those receivables. Clearly the purpose of s. 25 is to maintain the security over both the collateral and the proceeds where a secured party does not directly or indirectly authorize the factoring of the account receivable. In addition, under a factoring agreement, the value of the receivables will have been discounted (for early payment and/or risk of non-recovery) and it would be unfair to the Bank to limit recovery to the proceeds under the factoring agreement. Moreover, following *Acorn Partners,* there is no reason to exclude the proceeds recovered by the factor pursuant to the receivables.

Is recovery under s. 25 limited by the full amount of indebtedness or the value of the collateral?

[21] The more difficult issue is whether recovery of the proceeds pursuant to s. 25 is limited only by the full amount of the outstanding indebtedness secured by the GSA or whether it is also limited to the value of the collateral.

[22] Counsel advised that there are no cases dealing with the interpretation of s. 25 of the PPSA. While the section provides that the secured creditor can enforce against both the proceeds and the original collateral if certain conditions are satisfied, it does not impose any express limitation on the right to recovery. Obviously, some limitation is implicit in the PPSA regime and the language of the section is sufficiently broad that it does not dictate or preclude either limitation. In my view, the nature and extent of the limitation on recovery arises from an interpretation of the purposes and scheme of the Act.

[23] It is well established by the Supreme Court of Canada that a modern purposive approach to statutory interpretation requires that "words of an Act are to be read in their entire context and in their grammatical and ordinary sense harmoniously with the scheme of the Act, the object of the Act, and the intention of Parliament." Elmer Driedger in *Construction of Statutes* (2nd ed. 1983) at p. 87. See *Rizzo & Rizzo Shoes Ltd. (Re)*, [1998] 1 S.C.R. 27 at para. 21; *Bristol-Myers Squibb Co. v. Canada (Attorney General)*, [2005] 1 S.C.R. 533 at paras. 95-96.

[24] The *Legislation Act*, *2006,* S.O. 2006, c. 21, Sched. F, s. 64(1) further justifies a strong emphasis on a purposive approach: "An Act shall be interpreted as being remedial and shall be given such fair, large and liberal interpretation as best ensures the attainment of its objects."

[25] Every province in Canada except Ontario has a provision in its PPSA limiting recovery to the value of the collateral on the date of dealing where a secured party enforces against both the collateral and the proceeds: R.S.A. 2000, c. P-7, s. 28(1); R.S.B.C. 1996, c. 359, s. 28(1); C.C.S.M. c. P35, s. 28(1); S.N.L. 1998, c. P-7.1, s. 29(1); S.N.B. 1993, c. P-7.1, s. 28(2); S.N.S. 1995-96, c. 13, s. 29(2); R.S.P.E.I. 1988, c. P-3.1, s. 28(1); and S.S. 1993, c. P-6.2, s. 28(1).

[26] One policy rationale for this limitation was discussed by Prof. Ronald Cumming in the *British Columbia Personal Property Security Act Handbook*, (Toronto: Carswell, 1998) at p. 185:

> The secured party made her bargain with the debtor on the assumption that she would be secured to the value of the original collateral. The secured party did not contemplate having recourse to the proceeds since she did not give the debtor the right to deal with the original collateral in such a way as to create proceeds. The qualifier in s. 28(1) prevents s. 28(1)(b) from producing an unexpected windfall for the secured party by turning unsecured debt into secured debt at the expense of the debtor or the unsecured creditors of the debtor.

[27] In discussing the Ontario statute, Prof. Cumming, in *Personal Property Security Law* (Toronto: Irwin Law, 2005) at p. 461, noted that:

> The issue that has yet to be decided is whether the secured party will be able to proceed against the full value of both the original collateral and the proceeds, or whether a court will read into the statute a limitation similar to the one contained in the Acts of the other jurisdictions. The authors are of the opinion that such a limitation would be the most appropriate response. The basic premise behind the proceeds provisions is that the proceeds should stand in the place of the original collateral. Although a secured party has the right to claim both the original collateral and the proceeds where there has been a wrongful dealing by the debtor, this was intended to protect the secured party against a post-disposition deterioration in the value of the original collateral or the proceeds and was not intended to give an unexpected windfall to the secured party at the expense of the debtor or the unsecured creditors of the debtor.

[28] In *The 2010 Annotated Ontario Personal Property Security Act* (Toronto: Thompson Canada, 2009) at p. 213, Prof. Richard McLaren states that, where a "secured party claims an interest in both the collateral and the proceeds, the secured party is limited to the amount secured." He does not, however, provide any analysis in support of that position.

[29] The PPSA creates a notice and priority regime to provide protection to secured creditors and third parties, and to increase certainty and predictability in secured transactions. As noted by the Court of Appeal in *GE Canada Equipment Financing G.P. v. ING Insurance Co. of Canada*, 2009 ONCA 171 at para. 24:

> The PPSA is provincial chattel security legislation designed to protect the rights of creditors and debtors by regularizing secured transactions in personal property. To achieve this objective, the PPSA establishes a province-wide, notice-based registration system. … The purpose of such legislation was described by Gonthier J. (dissenting on other grounds) in *Royal Bank of Canada v. Sparrow Electric Corp.*, [1997] 1 S.C.R. 411, at para. 21:
>
> > [P]rovincial legislatures have moved to protect secured creditors generally through the enactment of personal property security legislation ... These statutory regimes have been implemented to increase certainty and predictability in secured

> transactions through the creation of a coherent system of priorities ... The benefits of such certainty in commercial transactions, on basic economic principles, are intended to accrue to the health of the economy in general.

[30] In addition, the PPSA provides protection and certainty to debtors to facilitate the use of personal property as collateral and to provide consistency and fairness in the enforcement of security interests: see *Saulnier v. Royal Bank of Canada,* [2008] 3 S.C.R. 166 at para. 19.

[31] On the one hand, limiting recovery under s. 25 by the amount of the debt secured by the collateral is anchored in the terms of the security agreement between secured creditor and debtor and the prior registration. There is no requirement that the value of the collateral be limited to the amount of the debt being secured. Indeed, the value of the collateral may well exceed the value of the debt being secured. Furthermore, the secured party does not authorize the disposition of the collateral and therefore does not have the opportunity to decide whether to accept any risks arising from the dealing with the collateral, while a third party will be put on notice by prior registration to investigate the nature and extent of the existing security interest. Such an interpretation focuses only on the recovery of the secured party who has prior registration and the total debt secured by that registration, rather than upon the collateral or upon the rights of the third party.

[32] On the other hand, an interpretation that limits recovery to the value of the receivable strikes a balance between the interests of the various parties, including the third party, and provides greater certainty and predictability in secured transactions. It gives the parties what they bargained for. Since the secured party only bargained for security over the value of the specific collateral, it should not be able to convert unsecured debt to secured debt simply because the collateral has been dealt with. While the Bank's priority should not be prejudiced by the transaction, there is no compelling reason why it should be able to recover a windfall - double recovery from the same collateral. As well, the structure of the notice regime in the PPSA provides a strong rationale for limiting recovery to the value of the collateral as of the date of dealing. A third party purchasing encumbered collateral will have no notice of the size of the debt secured, only of the fact that the collateral is subject to a prior security interest. To the extent the third party makes an error or chooses to risk a prior registered security interest, it is appropriate that they bear the risk of losing the collateral or the proceeds recovered if the amounts paid for the receivables are not paid to the secured creditor (in this case the Bank) and to the extent of any discount on the value of the receivables. However, sequential dealings with the collateral could generate more than one set of proceeds and create uncertainty with respect to the extent of a third party's liability. The focus of s. 25 is upon the collateral and the proceeds of dealing with the collateral. It provides the secured party with recourse to proceeds to ensure that any shortfall from the dealing with the assets can be remedied. Other provinces have made specific provision limiting recovery of the proceeds in such a way. Clearly such a principle is not generally destructive of a PPSA regime.

[33] For these reasons, I find that recovery under s. 25 of the PPSA is limited to the value of the collateral on the date of dealing. While an argument could be made that market value of the collateral as of the date of dealing should include a discount for pre-payment or the risk of non-recovery, it seems to me inappropriate to have the secured party pay for a discount that it did not authorize. In any event, I do not have the evidence in this case to determine the market value of

the receivables based upon the age of the receivables or the risk relating to collection. IPS could have sought the consent of the Bank but did not do so despite its notice of the Bank's prior perfected interest. Any risk associated with the collateral should be borne by the factor in these circumstances, rather than the Bank. I find that, in this case, the value of the collateral is the face value of the receivable.

[34] IPS advanced approximately $100,000 more than IPS collected. I do not agree that as a result, the Bank suffered no loss. This is not a claim for damages but rather a claim for priority and for proceeds under the PPSA regime.

[35] Based upon the IPS affidavit material, IPS advanced a percentage of the face value of the receivables and retained fees. IPS advises that it purchased invoices with a face value of $1,229,883.43 and US$554,854. IPS advanced to Blooming Rose and deposited with the Bank the sum of $1,118,620.98 and US$517,708.60. The difference representing the discount and fees appears to be $111,262.45 and US$37,145. However, if these numbers do not give effect to the principle that the Bank should recover the full face value of the receivables, to the extent it is greater than the monies IPS paid for the receivables and deposited to BNS, the parties may make brief written submissions with respect to the amount of the judgement (within 10 days.)

IPS: Waiver or Acquiescence

[36] IPS submits that BNS knew that Blooming Rose was factoring its accounts to IPS since cheques totalling $1.7 million were deposited to Blooming Rose's account with the BNS (in reduction of the indebtedness to BNS) during the period between September 2007 to December 2008. The name of "IPS Invoice Payment System Corp" was clearly marked as the payor and it would have been readily apparent that IPS was not an account debtor or customer. It submits that given its constructive notice of the deposit of the cheques, the Bank permitted the continued and regular purchase of accounts and that BNS waived or acquiesced in the factoring.

[37] The evidence is that BNS did not know who the payor was and did not see copies of the cheques: the cheques were managed by Simcor, a third party, who did not provide copies of the cheques unless requested and BNS did not make any such request. The Bank's evidence is that it demanded that the factoring cease as soon as it became aware in January 2009 as a result of the annual review. I accept the evidence that the Bank was unaware of the factoring prior to its meeting with Blooming Rose in January 2009. While the affiant did not have extensive personal knowledge, he was the current manager of the account and informed himself from speaking to the account manager and from the Bank's file, including the report of the January meeting. The monthly reports from Blooming Rose reported its outstanding receivables to the Bank without reference to the fact that they had been assigned to IPS. These facts do not support a finding that BNS was aware of the factoring prior to January 2009.

[38] While IPS submits that Simcor's knowledge as an agent for the Bank resulted in constructive notice to the BNS that cheques were from IPS Invoice Payment System Corp, I am not satisfied that even constructive knowledge of the payor of the cheques would support the inference that the Bank had knowledge that Blooming Rose was factoring its receivables with IPS or that as a result it did not intend to rely upon its legal rights. I do not find that these facts alone are capable of establishing waiver or estoppel. Such a finding would impose a positive

obligation on a bank to conduct detailed reviews of the cheques and further investigation in order to protect its security interest; this is neither required by law nor justified under commercial practice: see *Roclar Leasing Ltd. v McMillan Bloedel Ltd.,* [1988] O.J. No. 162 (H.C.J.) para. 34.

IBC: Waiver, Acquiescence, Estoppel

[39] IBC had assisted Blooming Rose with loans in 2006 and 2007. Due to the seasonal nature of its business, Blooming Rose needed financing in the latter half of the year because of the ramp up to its Christmas sales. In the summer and fall of 2008 IBC provided financing for the purchase of specific inventory that was to be sold to Wal-Mart. IBC made it a condition of advancing funds that the funds advanced would be earmarked to produce the material that would be supplied to Wal-Mart and that Blooming Rose would direct payments to IBC upon their sale.

[40] IBC submits that BNS had notice of IBC's involvement with Blooming Rose and acquiesced to the relationship. It submits the Bank's notice was based on the following:

> The June 30, 2006 and June 30, 2007 financial statements of Blooming Rose showed loans payable of $108,663 and $306,099 respectively;
>
> Blooming Rose advised the BNS that it would require bridge financing from other sources if the Bank did not finance its orders for Wal-Mart;
>
> The IBC cheques deposited to the BNS account: July 2- $70,000; August 6- $60,000; September 17- $190,000; and November 18- $60,000; and
>
> Blooming Rose's monthly accounts payable summaries for March, April and May 2007 cite amounts owing to IBC of $3000 to $6000.

[41] IBC therefore argues that: given the Bank would have been aware of a debt relationship prior to providing the credit facility; given its knowledge that seasonal bridge financing was required; given the size and round numbers of the IBC cheques and the fact that the cheques were noted as "loan proceeds" or "conditional loan proceeds;" and given the discrepancies between the size of the cheques and the amounts noted on the monthly accounts payable summaries, and the fact that the Bank monitored cash flow and profit margins, the Bank had constructive knowledge that IBC was providing inventory financing. IBC submits that these circumstances should have at least raised a suspicion that it was receiving funds that were not from a trade creditor and that the Bank was therefore wilfully blind or negligent in not following up as to the nature of the large deposits. The position of IBC is that the Bank had the means of knowledge, the information, the monitoring resources and the manpower to obtain knowledge and it benefited from IBC's activity.

[42] However, Blooming Rose did not disclose any indebtedness to IBC when it applied for financing in 2007. Furthermore, the financial statements did not identify the loans payable as owing to IBC. The payables disclosed relatively small amounts owing to IBC. The Bank did not see the cheques or request them. Although this account was subject to a pilot project with various risk triggers, no activity in this account generated significant transactions reports. To impute knowledge to the bank in these circumstances would effectively require the bank to maintain a very high standard of review and investigation in order to protect its registered security interest.

This is not required by the legislation or the case law and is not in my view commercially reasonable. The PPSA provides for registration in order to provide clear notice and to determine priority.

IBC: Licence to Sell

[43] I am satisfied the loan from IBC was made for the production of the specific inventory. IBC deposed that it advanced the funds on condition that they be earmarked for production of the specific inventory to be sold to Wal-Mart and on condition that it receive the payment for the inventory directly from Wal-Mart. Although the deponent for IBC testified that they had no specific mechanism to ensure that the advance was used for the production of inventory, he deposed that they had "regular monitoring" and that further the inventory was produced, sold to Wal-Mart and they paid for it. IBC applied the payment from Wal-Mart in repayment of the loan to Blooming Rose.

[44] IBC submits that BNS granted an implied license to Blooming Rose to deal with the inventory and therefore the GSA does not apply to the accounts receivable IBC collected from Wal-Mart. In *Royal Bank of Canada v Sparrow Electric Corp*, above, the Supreme Court of Canada held that a license to sell inventory authorizes the satisfaction of obligations that are immediately incidental to the actual sale of the inventory.

[45] I am not persuaded that there is evidence that the Bank granted an implied licence to Blooming Rose to deal with inventory in such a fashion. The evidence relied upon, above, for waiver or acquiescence does not support an inference of a licence to sell. Section 28 of the PPSA provides for an exception for a purchaser of goods in the ordinary course of business. However, accounts are not tangible personal property and therefore do not fall within the meaning of 'goods' as defined in s. 1 of the PPSA.

[46] In the absence of registration and notice, IBC cannot assert priority for inventory financing under the PPSA. According to ss. 20(1), 20(3), and 33, a PMSI will only obtain superiority where it is perfected by registration. IBC's interest is unperfected and is therefore subordinate to any other perfected security interest. Accordingly, IBC's security interest is subordinate to the interests of both BNS and IPS.

[47] For all these reasons, the monies IBC received from Wal-Mart are subject to the Bank's prior ranking security interest and the Bank should have judgment in the amount collected, subject to the full amount of the debt outstanding.

Decision

[48] For these reasons, accounts receivable of 1429030 Ontario Inc (Blooming Rose) collected by each of the respondents, directly from customers of Blooming Rose were subject to the Bank's prior ranking security interest in Blooming Rose's receivables.

[49] The Bank shall have judgment against IPS Invoice Payment System Corporations (IPS) in the amount of $111,262.45 and the Canadian dollar equivalent of US$37,145 (representing the discounted portion of the receivables). The Bank shall have judgment against Integrated Business Concepts Inc. (IBC) in the amount of $216,033.02. These amounts do not exceed the

total amount of Blooming Rose's indebtedness to the Bank of $442,698.01 and the Canadian dollar equivalent of US $33,193.95 (plus interest and costs). These amounts do not result in recovery of proceeds that exceed the face value of the receivables.

[50] If the parties cannot agree, brief written costs submissions may be filed within 21 days. Any replies within 10 further days.

A. KARAKATSANIS

Release Date:

2

CITATION: GE Canada Equipment Financing G.P. v. ING Insurance Company of Canada, 2009 ONCA 171
DATE: 20090225
DOCKET: C48486

COURT OF APPEAL FOR ONTARIO

Cronk, Juriansz and MacFarland JJ.A.

BETWEEN

GE Canada Equipment Financing G.P.

Applicant (Appellant)

and

ING Insurance Company of Canada

Respondent (Respondent in Appeal)

Harvey G. Chaiton and Doug Bourassa, for the appellant

Adam J. Stephens and Nafisah Chowdhury, for the respondent

Heard: October 2, 2008

On appeal from the order of Justice S.N. Lederman of the Superior Court of Justice dated February 4, 2008 and reported at 2008 CanLII 3413 (ON S.C.).

Cronk J.A.:

[1] This appeal involves a priority dispute between a secured creditor who holds perfected security interests under the *Personal Property Security Act*, R.S.O. 1990, c. P.10 (the "PPSA") in two highway tractor trucks and an automobile insurer who is entitled to salvage rights in the same vehicles under statutory condition 6(7) in *Statutory Conditions – Automobile Insurance*, O. Reg. 777/93 passed under the *Insurance Act*, R.S.O. 1990, c. I.8, as amended (the "Insurance Act"). At issue is the interplay between s. 4(1)(c) of the PPSA, which excludes "a transfer of an interest or claim in or under any policy of insurance" from the application of the PPSA, and statutory condition 6(7) of the Insurance Act, which affords an insurer the right to salvage in an insured vehicle in certain circumstances. We are also required to determine whether ss. 28(1) or 25(1) of the PPSA operate in this case to determine the priority contest between the parties.

I. Facts

(1) The Parties and the Events

[2] The appellant, GE Canada Equipment Financing G.P. ("GE"), an asset-backed lender, leases or conditionally sells various types of collateral, including highway tractor trucks. The respondent, ING Insurance Company of Canada ("ING"), offers a range of insurance products and services to the public, including automobile insurance. At the relevant time, Brampton Leasing and Rentals Limited ("Brampton") was in the vehicle leasing and rental business, operating as a Hertz car and truck rental agency.

[3] GE financed the purchase of numerous vehicles for use by Brampton in its leasing and rental business. In particular, on September 18, 2002 and November 18, 2004, GE entered into two conditional sale agreements (the "CSAs") with Brampton, whereby GE financed Brampton's acquisition of two highway tractor trucks manufactured in 2003 and 2005 (referred to in these reasons as the "2003 Truck", the "2005 Truck" or, collectively, the "Trucks").

[4] Under the terms of the CSAs: (i) GE was named as the "assignee" and Brampton was named as the "purchaser" of the Trucks; (ii) GE remained the owner of and held title to the Trucks until they were paid for in full; (iii) Brampton was required to place and maintain comprehensive first party all risks insurance on the Trucks for their full replacement value, to name GE as a beneficiary in the insurance policies so obtained, and to ensure that the policies contained a waiver of subrogation clause in favour of GE; and (iv) while not in default under the CSAs, Brampton was entitled to the quiet use and enjoyment of the Trucks.

[5] By the end of November 2004, GE had taken all necessary steps under the PPSA to perfect its purchase money security interests ("PMSIs") in the Trucks and their proceeds.[1]

[6] In accordance with its obligations under the CSAs, Brampton obtained comprehensive general liability insurance policies on the Trucks from Zurich Insurance Company, naming GE as loss payee thereunder. In addition, in February and May 2005, when Brampton leased the Trucks to two separate third parties, each lessee obtained automobile insurance on its leased vehicle under a policy of insurance issued by ING (the "ING policies"). The third parties were named as the insureds and lessees, and Brampton

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[1] In the CSA and financing change statement pertaining to the 2003 Truck, the assignee and secured creditor are identified as GE Capital Canada Equipment Financing Inc., rather than GE Canada Equipment Financing G.P. The parties did not address this discrepancy on this appeal. I therefore assume that it reflects a name change in relation to the appellant and that nothing turns on this issue.

was named as the lessor and loss payee under the ING policies. No mention was made of GE in the ING policies.

[7] After the ING policies were issued, both Trucks were stolen. As a result, in September 2005 and May 2006, the third party lessees completed loss claims and Brampton submitted proof of loss forms to ING in respect of the stolen Trucks. In the latter documents, Brampton falsely represented in relation to the Trucks: "[N]o person, firm, or corporation, other than the Insured, has had any interest therein, and there is no lien, chattel mortgage, or conditional sales agreement thereon."

[8] In consideration for the receipt of the ING insurance proceeds, Brampton also purported to transfer title to the Trucks to ING in circumstances of a vehicle total loss claim (the "Transfer"). The proof of loss forms stated:

> Payment of this claim to [the insured and Brampton] is hereby authorized and in consideration of such payment the Insurer is discharged forever from all further claim by reason of the said loss or damage. All rights to recovery from any other person are hereby transferred to the Insurer which is authorized to bring action in the Insured's name to enforce such rights. *All right, title and interest in the vehicle or any part or equipment thereof is hereby transferred to the Insurer only in the event that this claim is based upon the whole value of the vehicle because it has been lost, destroyed or damaged beyond economical repair and the Insured agrees immediately to notify the Insurer in the event of its recovery.* [Emphasis added.]

The record does not reveal how the Transfer contemplated by this provision was actually made.

[9] ING accepted the loss claims and discharged its indemnity obligations under the ING policies by paying the cash value of the stolen Trucks jointly to Brampton and the third party lessees, less applicable deductibles. As a result, as I discuss later in these reasons, ING became entitled to salvage rights in the Trucks under statutory condition 6(7) of the Insurance Act.

[10] ING did not conduct PPSA searches prior to issuing the ING policies, paying the ING insurance proceeds, or accepting title to the Trucks from Brampton.

[11] Both Trucks were later recovered and ING took possession of them. ING then sold the 2005 Truck to an unrelated party. As a result of this litigation, ING has retained possession of the 2003 Truck and the proceeds from the sale of the 2005 Truck.

[12] Brampton did not notify GE of the theft of the Trucks. On the contrary. it continued to make payments to GE under the CSAs for some months after the Trucks were stolen. Similarly. GE received no notice of the terms of the ING policies. the claims made thereunder by Brampton and the third party lessees. the payment to them of the ING insurance proceeds. or the Transfer. None of the ING insurance proceeds was remitted to GE.

[13] Brampton defaulted in its payment obligations under the CSAs in December 2006 and filed an assignment in bankruptcy on March 1. 2007. GE learned of the theft of the Trucks when it attempted to exercise its remedies on default under the CSAs. On March 14, 2007. GE obtained used vehicle information packages for the Trucks from the Ministry of Transportation. which indicated that ING was the registered owner of the 2003 Truck and that it had owned. and subsequently sold. the 2005 Truck. The packages also identified GE as a "secured party" and a registered lienholder in relation to both Trucks.

[14] There is no suggestion that the third party lessees or ING knew of GE's PMSIs in the Trucks prior to the end of March 2007. when GE wrote to ING and informed it of GE's perfected PMSIs in the Trucks. Brampton. of course. knew of GE's PMSIs throughout.

(2) Relevant Statutory Provisions

[15] The following statutory provisions are central to the issues on appeal:

A. The PPSA:

> 4.(1) Except as otherwise provided under this Act. this Act does not apply,
>
> ...
>
> (c) to a transfer of an interest or claim in or under any policy of insurance ...
>
> ....
>
> 9.(1) Except as otherwise provided by this or any other Act. a security agreement is effective according to its terms between the parties to it and against third parties.
>
> ....
>
> 25.(1) Where collateral gives rise to proceeds. the security interest therein.

> (a) continues as to the collateral. unless the secured party expressly or impliedly authorized the dealing with the collateral free of the security interest: and
>
> (b) extends to the proceeds.
>
> ....
>
> 28.(1) A buyer of goods from a seller who sells the goods in the ordinary course of business takes them free from any security interest therein given by the seller even though it is perfected and the buyer knows of it, unless the buyer also knew that the sale constituted a breach of the security agreement.

B. Statutory Condition 6(7) of the Insurance Act:

> There shall be no abandonment of the automobile to the insurer without the insurer's consent. If the insurer exercises the option to replace the automobile or pays the actual cash value of the automobile, the salvage, if any, shall vest in the insurer.

(3) The Litigation

[16] Despite demand therefor, ING refused to surrender possession of the 2003 Truck or to pay the proceeds from the sale of the 2005 Truck to GE. As a result. GE commenced proceedings against ING. applying for declarations that: (i) its PMSIs in the Trucks had priority over ING's rights to salvage in the same vehicles: and (ii) it was entitled to the return of the Trucks or, in the case of the 2005 Truck, to the proceeds of sale thereof, from ING.

[17] ING resisted GE's application on two grounds. It maintained that its salvage rights flowed from the ING policies, which incorporated statutory condition 6(7) of the Insurance Act, and that the PPSA did not apply to its interests in the Trucks by virtue of s. 4(1)(c) of the PPSA and statutory condition 6(7) of the Insurance Act. ING also argued that as the Transfer was a "[sale] in the ordinary course of business". the PPSA did not apply by operation of s. 28(1) of the PPSA. On both grounds. ING asserted that it took title to the Trucks free from GE's pre-existing perfected PMSIs in the Trucks.

[18] By order dated February 4, 2008, the application judge dismissed GE's application and, on consent, awarded costs to ING in the total amount of $15,000. plus interest. The core of his reasoning was as follows:

> As a matter of priority, the PPSA, in effect, has stated that GE is not to have priority over transfers of interest to ING by reason of the operation of Statutory Condition 6(7) which is incorporated into insurance policies.
>
> Conclusion
>
> I find that GE's interest in the vehicles *vis a vis* ING is not protected by the PPSA for the reason that [the] PPSA does not apply to a transfer of an interest under a policy of insurance [s. 4(1)(c) of the PPSA]. There was such a transfer of an interest by virtue of Statutory Condition 6(7).

[19] Given this conclusion, the application judge regarded it as unnecessary to address ING's s. 28(1) PPSA argument. In contrast to its position on this appeal, ING did not rely on s. 25(1) of the PPSA in the proceeding before the application judge.

II. Issues

[20] I would frame the issues on appeal this way: do ING's salvage rights in the Trucks have priority over GE's pre-existing perfected PMSIs in the Trucks and their proceeds by operation of: (i) s. 4(1)(c) of the PPSA and statutory condition 6(7) of the Insurance Act: (ii) s. 28(1) of the PPSA: or (iii) s. 25(1) of the PPSA?

III. Analysis

[21] GE advances two main arguments in support of its claim that its PMSIs have priority over ING's salvage rights. It submits that the application judge erred by concluding that the combined operation of s. 4(1)(c) of the PPSA and statutory condition 6(7) of the Insurance Act resulted in title to the Trucks vesting in ING free from GE's perfected PMSIs in the Trucks and their proceeds. GE also asserts that neither s. 28(1) nor s. 25(1) of the PPSA are engaged in this case since, in the case of s. 28(1), the Transfer was not a "[sale] in the ordinary course of business" and, in the case of s. 25(1), GE did not expressly or impliedly authorize the Transfer. I will address these arguments in turn.

[22] To begin, I note that the issues on appeal relate to the interpretation of the relevant PPSA provisions and statutory condition 6(7) of the Insurance Act. The process of statutory interpretation is governed by the modern rule of statutory construction, first described in E.A. Driedger, *Construction of Statutes*, 2nd ed. (Toronto: Butterworths, 1983) at p. 87:

> Today there is only one principle or approach. namely. the words of an Act are to be read in their entire context and in their grammatical and ordinary sense harmoniously with the scheme of the Act. the object of the Act. and the intention of Parliament.

See also: Ruth Sullivan. *Sullivan and Driedger on the Construction of Statutes*. 4th ed. (Toronto: Butterworths. 2002) at pp. 1-3; *Bell ExpressVu Ltd. Partnership v. Rex*, [2002] 2 S.C.R. 559. at para. 26; and *Rizzo & Rizzo Shoes Ltd. (Re)*, [1998] 1 S.C.R. 27, at para. 21.

(1) Section 4(1)(c) of the PPSA and Statutory Condition 6(7) of the Insurance Act

[23] The application judge concluded that the combined effect of s. 4(1)(c) of the PPSA and statutory condition 6(7) of the Insurance Act was to deprive GE of the priority protection otherwise afforded to its PMSIs under the PPSA. With respect, I disagree.

(i) PPSA regime

[24] The PPSA is provincial chattel security legislation designed to protect the rights of creditors and debtors by regularizing secured transactions in personal property. To achieve this objective. the PPSA establishes a province-wide. notice-based registration system. Under this system. the first creditor to register notice of a security interest in a debtor's personal property generally has a first priority secured interest in that property that is effective against third parties, including other secured creditors: see *Royal Bank of Canada (Administrative agent for certain lenders) v. 1231640 Ontario Inc. (Trustee of)*, 2007 ONCA 810. at para. 4 *per* Weiler J.A. (in dissent. but not on this point). leave to appeal to S.C.C. granted, [2008] S.C.C.A. No. 34. The purpose of such legislation was described by Gonthier J. (dissenting on other grounds) in *Royal Bank of Canada v. Sparrow Electric Corp.*, [1997] 1 S.C.R. 411. at para. 21:

> [P]rovincial legislatures have moved to protect secured creditors generally through the enactment of personal property security legislation ... These statutory regimes have been implemented to increase certainty and predictability in secured transactions through the creation of a coherent system of priorities ... The benefits of such certainty in commercial transactions, on basic economic principles. are intended to accrue to the health of the economy in general.

[25] Section 2 of the PPSA delineates the scope of the statute:

> Subject to subsection 4(1). this Act applies to.

> (a) every transaction without regard to its form and without regard to the person who has title to the collateral that in substance creates a security interest including, without limiting the foregoing,
>
> (i) a ... conditional sale ... and
>
> (ii) an assignment, lease or consignment that secures payment or performance of an obligation;

Thus, under s. 2(a) and subject to s. 4(1), the PPSA applied to GE's security interests in the Trucks, as created under the CSAs.

[26] The central priorities rule under the PPSA is set out in s. 9(1): "*Except as otherwise provided by this or any other Act*, a security agreement is effective according to its terms between the parties to it and against third parties" (emphasis added).

[27] In this case, GE's PMSIs in the Trucks were perfected by registration under the PPSA before the issuance of the ING policies and the Transfer. As a result, under the s. 9(1) priorities rule, GE's PMSIs have priority over the interests of all third parties with a subsequently acquired interest in the secured collateral. The issue, therefore, is whether s. 4(1)(c) of the PPSA and statutory condition 6(7) of the Insurance Act, alone or in combination, constitute an exception to the s. 9(1) PPSA priorities rule, such that ING's salvage rights in the Trucks overtake the priority of GE's PMSIs in the same collateral.

(ii) Section 4(1)(c) PPSA exclusion

[28] Section 4(1)(c) of the PPSA excludes transfers of "an interest or claim in or under any policy of insurance" from the application of the PPSA. Jacob S. Ziegel and David L. Denomme, in *The Ontario Personal Property Security Act: Commentary and Analysis*, 2nd ed. (Toronto and Vancouver: Butterworths, 2000) at p. 82, citing F.M. Catzman, Q.C., *Personal Property Security Law in Ontario* (Toronto: Carswell, 1976) at p. 35, explain the rationale for the s. 4(1)(c) exclusion in this fashion:

> The drafters of the original Ontario Act rationalized the exclusion of security interests in insurance policies on the ground that the insurer maintains records of title and claims to policies and contracts issued by it and that there was no need for a separate registry.

See also *Rektor (Re)*, [1983] O.J. No. 957 (H.C.J.), at para. 11.

[29] Thus, the purpose of s. 4(1)(c) is to avoid the unnecessary duplication of notice systems concerning transfers that create interests or claims in or under insurance policies. This is achieved by excluding such interests or claims from the PPSA notice and

registration scheme. Simply put. notice under the PPSA is not required to perfect a security interest falling within the ambit of s. 4(1)(c).

[30] In *Stelco Inc. (Re)*. 2005 CanLII 13192 (ON C.A.). this court was concerned with whether an assignment of unearned premium under an insurance premium financing contract came within the s. 4(1)(c) exclusion. Justice Weiler. writing for the court, examined the scope of s. 4(1)(c) and noted that its purpose is to exempt certain items of commerce from the notice and registration requirements of the PPSA. She commented, at paras. 10, 15. 21-22 and 24:

> [Section] 4(1)(c) deals specifically with transfers of interests or claims in insurance policies. It does not deal with "other items of commerce" and these are not exempted [from the application of the PPSA].
>
> ....
>
> The wording of the exclusion in s. 4(1)(c) is clear and should be read as including the assignment of unearned premium under a policy of insurance.
>
> ....
>
> *In Ontario, interpreting s. 4(1) as exempting [the premium financier] from registering its right to receive any unearned insurance premium leads one to s. 138 of the Insurance Act* [which provides for notice of an insured's assignment of the right to refund of premium under a contract of insurance].
>
> This is not to say that s. 138 gives [the premium financier] the right to priority over other secured lenders. To determine priorities, resort to the common law or to the provisions of the *Bankruptcy and Insolvency Act*, R.S.C. 1985, c. B-3 would be necessary and that issue awaits another day.
>
> ....
>
> [The premium financier] has an interest in the unearned premiums that were transferred to it by virtue of the [contracts in issue] and ... *that security interest was exempt from registration by virtue of a combination of s. 4(1)(c) of the PPSA and s. 138 of the Insurance Act.* [Emphasis added.]

[31] The effect of s. 4(1)(c) in this case, therefore, was to relieve ING of the obligation to protect its interests under the ING policies by providing notice of those interests in the PPSA registry. But s. 4(1)(c) did no more. It did not relieve ING of the requirement to

be mindful of the PPSA-protected interests of secured creditors. Nothing in the language of s. 4(1)(c) suggests that it is intended to resolve priority disputes between creditors, including priority competitions between a creditor with a perfected security interest under the PPSA (like GE) and a creditor whose interest in collateral is exempt from the notice and registration requirements of the PPSA (like ING).

[32] Indeed, a consideration of the language of s. 4(1)(c) in the context of its purpose indicates that s. 4(1)(c) is not concerned with priorities at all. The words of Professors Ziegel and Denomme at p. 116 of their above-cited text, although addressing another exclusion from the PPSA under s. 4(1)(a), apply with equal force to s. 4(1)(c):

> [Section] 4(1)(a) means not only that the Act has nothing to say about the creation and perfection of non-consensual security interests but also that *it does not regulate priorities between PPSA security interests and non-PPSA interests.* [Emphasis added.]

[33] Accordingly, since s. 4(1)(c) of the PPSA does not address priorities, it does not operate to oust the priority otherwise conferred on GE's PMSIs by s. 9(1) of the PPSA.

[34] This conclusion is bolstered by the nature of the transaction at issue. GE submits that s. 4(1)(c) does not apply to resolve the priority contest between the parties because the Transfer did not "in substance create a security interest" in or under an insurance policy or amounts payable under an insurance policy. Thus, it is contended that the Transfer did not fall within the ambit of s. 4(1)(c). I agree.

[35] Section 4(1)(c) of the PPSA is modelled after Article 9 of the Uniform Commercial Code (the "UCC"), which establishes exceptions from similar personal property registration schemes in the United States. UCC 9-109(d)(8) provides:

> 9-109(d) This article does not apply to:
>
> (8) a transfer of an interest in or an assignment of a claim under a policy of insurance...

[36] Prior to July 1, 2001, the wording of UCC 9-104(g) – the predecessor provision to current UCC 9-109(d)(8) – was identical to that of s. 4(1)(c) of the PPSA. The ambit of UCC 9-104(g) was interpreted by American courts as limited to direct interests created in an insurance policy by making the policy itself the collateral securing the transaction in question. Thus, for example, in *Paskow v. Calvert Fire Insurance Co.* 579 F. 2d 949, 953 (5th Cir. 1979), the court explained that UCC 9-104(g) was "directed not at the insurance of collateral but the creation of a security interest *in an insurance policy*" (emphasis added). See also *PPG Industries v. Hartford Fire Ins. Co.* 531 F. 2d 58, 60 (2nd Cir. 1976).

[37] The Transfer in this case was not a secured transaction – it did not create an interest that secured payment or performance of an obligation. Nor did it create a security interest "in or under an insurance policy", including in respect of amounts payable under an insurance policy, so as to trigger the application of s. 4(1)(c) of the PPSA. Rather, it involved the purported transfer of ownership in the Trucks to ING in exchange for full indemnification under the ING policies on the basis of a total loss claim.

[38] I note that GE makes no claim to the ING policies or their proceeds. Its claims are to the collateral secured by the CSAs – the Trucks – and, in the case of the 2005 Truck, to the proceeds of sale realized by ING, in respect of which GE holds PPSA-protected security interests. GE's claims, therefore, are unaffected by s. 4(1)(c). Its claims are based on "PPSA security interests" in the Trucks and, in respect of the 2005 Truck, in its proceeds. In contrast, ING's interests in or under the ING policies and its salvage rights in the Trucks are "non-PPSA interests".

[39] In all these circumstances, I agree with GE's submission that s. 4(1)(c) does not operate in this case to determine the priorities between GE's PPSA security interests in the Trucks and their proceeds and ING's non-PPSA salvage rights in the Trucks. Section 4(1)(c) simply has no bearing on that key issue.

[40] However, that does not end the matter. In the application judge's view, it was the combined operation of s. 4(1)(c) and statutory condition 6(7) that determined this priority contest. Recall that he held that GE's interest in the vehicles, "is not protected by the PPSA for the reason that [the] PPSA does not apply to a transfer of an interest under a policy of insurance" and "There was such a transfer of an interest by virtue of Statutory Condition 6(7)." I turn now to consideration of statutory condition 6(7).

(iii) Statutory condition 6(7)

[41] Under s. 234(1) of the Insurance Act, statutory condition 6(7) forms part of the standard form automobile insurance policy in use in Ontario.[2] Statutory condition 6(7) is concerned with automobile total loss cases. In such cases, an insurer is entitled to the salvage, if any, in the lost automobile where it elects to replace or pay the actual cash value of the automobile. In *David Polowin Real Estate Ltd. v. Dominion of Canada General Insurance Co.* (2005), 76 O.R. (3d) 161, at para. 54, leave to appeal to S.C.C. refused, [2005] S.C.C.A. No. 388, this court explained that statutory condition 6(7) affords an insurer three options where an insured vehicle is a total loss:

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[2] Section 234(1) of the Act states, in part: "The conditions prescribed by the regulations made under paragraph 15.1 of subsection 121(1) are statutory conditions and shall be deemed to be part of every contract to which they apply ..."

> First. the insurer can replace the insured's car and take title to the salvage. It is entitled to the salvage because otherwise. its insured will be over-indemnified. Second. it can pay the actual cash value of the car and take title to the salvage. Again. the insurer claims entitlement to the salvage to prevent over-indemnification. Third. it can elect to leave the salvage with the insured. in which case the insured's loss would not be the actual cash value of the car but its diminution in value.

[42] In this case. the Trucks were lost through theft. On proof of loss, ING exercised the second option described in *Polowin* – it paid Brampton and the third party lessees the actual cash value of the Trucks. less applicable deductibles. in exchange for the Transfer. Having satisfied its indemnity obligations under the ING policies in full. ING became entitled under statutory condition 6(7) to title to any salvage in the Trucks. But this does not mean that statutory condition 6(7) operates to vest title to the salvage in ING. free and clear of pre-existing perfected security interests in the Trucks. I say this for several reasons.

[43] First. the concepts of priority and salvage are not the same. Statutory condition 6(7) does not refer to priorities. the interests of secured creditors, or the PPSA. It refers to the right to salvage in respect of a total loss insured vehicle. A plain reading of statutory condition 6(7) offers no support for ING's contention that it is intended, alone or in combination with s. 4(1)(c) of the PPSA, to extinguish a creditor's pre-existing perfected security interest in a vehicle that becomes the subject of a total loss claim. For example, statutory condition 6(7) does not contain the words "notwithstanding any security interest in the vehicle". It is. of course. open to the legislature to create a right that extinguishes or subordinates the pre-existing perfected security interests of third parties. But if this were the intent of statutory condition 6(7), it could easily have been accomplished by the use of explicit priorities language.

[44] This conclusion is fortified by the decision of the Supreme Court of Canada in *Sparrow*. In that case, Iacobucci J., writing for a majority of the court, confirmed at paras. 106 and 112, that clear and unambiguous language is required to extinguish the rights of a secured creditor in respect of collateral:

> Parliament has shown that it knows how to assert priority over rival security interests ... All that is needed to overtake a fixed and specific charge is clear language to that effect.
>
> Finally, I wish to emphasize that it is open to Parliament to step in and assign absolute priority to the deemed trust. A clear illustration of how this might be done is afforded by s. 224(1.2) [of the *Income Tax Act*]. which vests certain

> moneys in the Crown "notwithstanding any security interest in those moneys" and provides that they "shall be paid to the Receiver General in priority to any such security interest". All that is needed to effect the desired result is clear language of that kind. [Citations omitted.]

See also *First Vancouver Finance v. Canada (Minister of National Revenue – M.N.R.)*, [2002] 2 S.C.R. 720, at paras. 26-28; *DaimlerChrysler Financial Services (Debis) Canada Inc. v. Mega Pets Ltd.*, 2002 BCCA 242, at para. 38.

[45] In contrast to the explicit Crown priority provision referenced in *Sparrow*, statutory condition 6(7) is devoid of any express or implied indicators of a legislative intent to affect the perfected security interest of a secured creditor in an insured vehicle that is lost to an insured. In my view, to read such an intent into statutory condition 6(7) in the absence of clear and unequivocal language evidencing such a legislative objective would constitute an unwarranted extension of the scope of an insurer's salvage rights.

[46] Second, and importantly, statutory condition 6(7) represents a statutory codification of the common law right of subrogation. In *Polowin*, Laskin J.A., writing for a unanimous court, held at para. 82 that an insurer's right to claim salvage under statutory condition 6(7), "amounts to the exercise of the right of subrogation after fully indemnifying the insured for the insured's loss". He later added at para. 100: "Once an insured has been fully indemnified for the loss, the right to salvage is simply the exercise of the right of subrogation to prevent over-indemnification [of the insured]."

[47] Subrogation is a derivative right that rests on the principle of indemnification. It contemplates that on full indemnification of an insured by an insurer for an insured loss, the insurer becomes entitled to exercise a right belonging to the insured. In *Insurance Law* (Toronto: Irwin Law, 2004), Denis Boivin states at pp. 280, 282 and 284:

> Subrogation arises when the insured has an enforceable right against someone other than his or her insurer – a right that would allow the insured to recover the losses caused by the peril, in part or in their entirety. Subrogation allows the insurer to enforce this right in the name of the insured and to withhold from the resulting award the equivalent of any indemnity paid under the insurance contract.
>
> ....
>
> <u>The insurer must be placed in the exact same position as the insured</u>. The insurer must have access to *all* the rights and remedies of the insured with respect to the insured object ...
>
> ....

<u>Subrogation is a derivative right – that is, it depends entirely on the rights of the insured.</u>

[Italicized emphasis in original; Underlined emphasis added.]

[48] In other words, under the principle of subrogation, the insurer succeeds only to the exact right otherwise enjoyed by its insured. This is not a new proposition. It has long been recognized that under the right of subrogation, the insurer must be placed in the position of its insured. For this reason, the discussion in *Polowin* of an insurer's exercise of the right of subrogation under statutory condition 6(7) recognizes that prior to the insurer's election to trigger statutory condition 6(7), the right to salvage in an insured vehicle is a property right of the insured. Where, however, the insurer pays the insured's total loss claim in respect of the insured vehicle, it becomes entitled to all the salvage rights that the insured possessed in respect of the insured vehicle. Statutory condition 6(7), therefore, is concerned with an insurer's right to salvage as against its insured.

[49] The application judge does not appear to have considered the implications of the principle of subrogation in the context of statutory condition 6(7). Instead, relying on *Re Giffen*, [1998] 1 S.C.R. 91, he concluded that the dispute between GE and ING could not be resolved on the basis of the examination of Brampton's rights in respect of the Trucks or the determination of who has title to the vehicles, "because the dispute is one of priority to the vehicles and not ownership in them".

[50] I agree that we are concerned here with the priorities as between GE's and ING's interests in the Trucks. I also agree that the question of title to or ownership of collateral is not determinative of priorities under the PPSA: see for example, *Giffen*, at para. 26. However, the pertinent issue is the reach of ING's rights under statutory condition 6(7).

[51] Under statutory condition 6(7), where an insurer decides to replace or pay the actual cash value of a total loss vehicle, the salvage in the vehicle, if any, vests in the insurer by operation of law. Where, as here, the prerequisites to the invocation of statutory condition 6(7) are met, the issue is whether any salvage is in fact available for the benefit of the insurer. In some cases, no salvage will exist. For this reason, statutory condition 6(7) refers to salvage, "if any". Where salvage is available, the issue is whether the insurer's salvage right has priority over pre-existing perfected security interests in the vehicle in respect of which the salvage right arises.

[52] Where – as here – salvage is available, the principle of subrogation that underlies statutory condition 6(7) and the requirement of indemnification on which that principle rests, mandate that an insurer who replaces or pays the actual cash value of an automobile in a total loss case steps into the shoes of the insured in relation to the right to salvage. The insurer is only entitled under the subrogation principle to the salvage right that was enjoyed by its insured prior to the insurer's decision to invoke statutory condition 6(7).

[53] In this case, Brampton's interests in the Trucks were subject to GE's perfected PMSIs. Statutory condition 6(7) conferred on ING only those rights to salvage possessed by Brampton prior to ING's payment of the actual cash value of the Trucks. Absent express statutory language to the contrary, statutory condition 6(7) should not be interpreted so as to confer on Brampton's insurer greater rights to salvage in the Trucks than were held by Brampton.

[54] In other words, statutory condition 6(7) does not increase the rights of an insurer against third parties beyond those enjoyed by its insured, or create new rights in the insurer not previously possessed by its insured. The 'vesting' of salvage rights that occurs under statutory condition 6(7) involves the conveyance of salvage rights as between an insurer and its insured. That transfer may be subject to the interests of the insured's secured creditors.

[55] This conclusion accords with both commercial and common sense. If ING's assertion of priority is accepted, it would mean that a debtor whose vehicle was subject to the perfected security interest of a secured creditor could defeat that interest by the simple device of purchasing automobile insurance on the secured vehicle. In the subsequent event of the total loss of the vehicle, the interest of the secured creditor could be extinguished, without recourse, at the unilateral election of the debtor's insurer. This result would offend the principle of subrogation. It would permit a debtor's insurer to enjoy greater rights in the insured collateral than the debtor itself possessed. This is not a reasonable result. It is, therefore, to be avoided unless a legislative intent to effect such a result is evident. No such intent is manifest in statutory condition 6(7).

[56] The application judge relied on *Chrysler Credit Canada v. Fehr* (2001), 55 O.R. (3d) 430 (S.C.) for the proposition that an insurer's entitlement to salvage under statutory condition 6(7) "was exempt from a claim under the PPSA". In so doing, he adverted to the following passage from *Chrysler Credit*, at para. 11:

> The issue before me is not one of a transfer of an interest in a policy of automobile insurance. The issue before me does not include an insurer's right under [s. 6(7)] of the statutory conditions, which are incorporated in the policy, to acquire title to the salvage. Accordingly, the PPSA does not apply to the insurer's right to acquire the salvage of the collateral.

[57] I acknowledge that many of the facts in *Chrysler Credit* are analogous to those in this case. However, *Chrysler Credit* is distinguishable from the case at bar in several pivotal respects. Unlike this case, *Chrysler Credit* involved a claim by a secured creditor for entitlement to the proceeds of an insurance policy on a destroyed vehicle after the debtor's insurer had paid the debtor for the vehicle loss. That is not this case. As I have emphasized, GE makes no claim to the proceeds of the ING policies.

[58] Moreover, s. 258(3) of the Insurance Act was crucial to the decision in *Chrysler Credit*. That provision deals with the application of insurance money payable under an automobile insurance policy. It provides that an insured's creditor is not entitled to share in the insurance money payable under the policy unless the creditor's claim is "one for which indemnity is provided for by [the policy]". As there was no evidence that Chrysler Credit was a named insured or loss payee under the policy in question, it was precluded under s. 258(3) from claiming entitlement to the insurance proceeds and was restricted to its contractual rights against the debtor. Section 258(3) of the Insurance Act does not apply in this case, as GE seeks to obtain the secured collateral and proceeds from the sale of part of the secured collateral, rather than the proceeds of the ING policies themselves.

[59] Finally, in my view, *Chrysler Credit* does not hold that an insurer's right to salvage has priority over a secured party's interests in the automobile that gives rise to the salvage rights. Rather, the passage from *Chrysler Credit* relied on by the application judge concerns the rights of an insurer, as against its insured, to obtain salvage rights in insured collateral. In that context, *Chrysler Credit* holds that s. 4(1)(c) of the PPSA does not apply to an insurer's salvage rights.

(iv) Summary

[60] I would summarize my conclusions concerning s. 4(1)(c) of the PPSA and statutory condition 6(7) of the Insurance Act as follows:

> (i) Section 4(1)(c) and statutory condition 6(7) do not address priorities. To determine priorities in this case, resort must be had to s. 9(1) of the PPSA. Neither s. 4(1)(c) of the PPSA nor statutory condition 6(7) of the Insurance Act, alone or in combination, constitute an exception to the s. 9(1) PPSA general priorities rule. On the facts of this case, GE's PMSIs in the Trucks are effective as against ING under s. 9(1).
>
> (ii) Under s. 4(1)(c), ING was relieved of the obligation to provide notice of its interests under the ING policies in the PPSA registry. However, while s. 4(1)(c) freed ING from the need to protect its own interests under the PPSA, it did not relieve it of the requirement to be mindful of the PPSA-protected interests of other parties in the same collateral.
>
> (iii) The reach of ING's salvage rights under statutory condition 6(7) is determined by Brampton's salvage rights as they existed before ING triggered statutory condition 6(7). Brampton's salvage rights in the Trucks did not extinguish or displace the priority of GE's PMSIs in the Trucks and their

> proceeds. As against GE. therefore. ING is in no better position in respect of its salvage rights than was Brampton.

(2) Section 28(1) of the PPSA

[61] ING argues that the Transfer was a usual transaction for a leasing company, with the result that it was a "sale" in the "ordinary course of business" by Brampton, within the meaning of s. 28(1) of the PPSA. Consequently, ING asserts, it took title to the Trucks under the Transfer free from GE's PMSIs. I again set out s. 28(1) of the PPSA:

> **28.** (1) A buyer of goods from a seller who sells the goods in the ordinary course of business takes them free from any security interest therein given by the seller even though it is perfected and the buyer knows of it, unless the buyer also knew that the sale constituted a breach of the security agreement. [3]

[62] I disagree for two reasons. First, I am not persuaded that the Transfer from Brampton to ING constituted a "sale" for the purpose of s. 28(1) of the PPSA. G.H.L. Fridman. Q.C.. in his text entitled *Sale of Goods in Canada*. 5th ed. (Toronto: Carswell. 2004) notes at pp.11-12:

> At common law there appear to be instances in which property in goods is compulsorily transferred by the law from one person to another. *In such cases there is no purchase, the parties do not stand in the relationship of seller and buyer to each other, and there is no sale of goods. ... In such instances, there is no bilateral transaction which can be called a contract of sale*; nonetheless, the effect of what has happened is the transfer of property in goods from one person to another. [Emphasis added.]

[63] These comments are apposite here. ING did not offer to buy and Brampton did not offer to sell the Trucks. No agreement of purchase and sale was entered into by the parties. Instead. ING's acquisition of title to the Trucks occurred in the context of an insurer's contractual relationship with its insured and the insured's loss payee, as a condition of Brampton's receipt of the cash value of the Trucks under the ING policies.

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[3] Section 28(5) of the PPSA extends the reach of s. 28 to include sales of motor vehicles out of the ordinary course of business in certain circumstances, unless the vehicle identification number (VIN) of the motor vehicle is set out in a registered financing or financing change statement filed under the PPSA, or unless the buyer knew that the sale constituted a breach of the applicable security agreement. ING does not suggest that s. 28(5) is engaged in this case. GE properly registered its interest in each of the Trucks under the PPSA, listing the VINs of each Truck in separate registrations.

Under statutory condition 6(7). ING became entitled to the salvage in the Trucks on its election to pay the actual cash value of the lost Trucks. Once ING so elected, its entitlement to its insured's salvage rights in the Trucks occurred by operation of law.

[64] In these circumstances, to quote Professor Fridman, there was no "purchase", the parties did not "stand in the relationship of seller and buyer to each other", there was "no sale of goods", and there was no true "contract of sale" between ING and Brampton.

[65] Second, even if the Transfer could be said to have constituted a "sale" for the purpose of s. 28(1), this record does not support the contention that the Transfer was carried out by Brampton in the "ordinary course of business", as required under s. 28(1).

[66] The test for determining whether a transaction is a sale in the ordinary course of business is uncontroversial. It is a question of fact to be objectively assessed, based on all the circumstances of the particular case: *Bank of Nova Scotia v. Groupe Procycle Inc.*, [1999] O.J. No. 24 (S.C.), at para. 21; and *Fairline Boats Ltd. v. Leger*, [1980] O.J. No. 216 (H.C.J.), at para. 12. Several factors compel the conclusion that the Transfer was not a transaction carried out by Brampton in the "ordinary course of business".

[67] The record shows that Brampton was in the vehicle leasing and rental business. There was no evidence before the application judge – and none has been adduced before this court – establishing that Brampton's business also included the sale of vehicles. The record is silent as to what Brampton did with its inventory of leased vehicles at the end of their lease terms. This gap in the evidential record distinguishes this case from those cases relied on by ING in which the nature of the debtor's business required it to revolve its inventory by selling vehicles to customers in order to retire the debtor's debts and continue its business.

[68] ING has adduced fresh evidence indicating that Brampton was a registered dealer and salesperson with the Ontario Motor Vehicle Industry Council. The fact of this registration is not dispositive of whether Brampton's ordinary business actually included the sale of vehicles. It simply means that Brampton held the necessary registration to sell vehicles if it chose to do so. There is no evidence that it so elected or that the sale of vehicles was a necessary and commonplace, or even an occasional component of its day-to-day business.

[69] The record also establishes that:

(i) Brampton did not own the Trucks;

(ii) Brampton did not market the Trucks to the public or to ING. On the contrary, the Transfer involved a compulsory acquisition by ING of title to the Trucks as a condition of payment under the ING policies;

(iii) ING was not a regular customer of Brampton;

(iv) the amount of the insurance proceeds paid by ING was not market-driven. Rather, it represented the cash value of the Trucks, which ING elected to pay as full indemnification under the ING policies; and

(v) the transfer of possession of the Trucks to ING was not a condition of payment of the ING insurance proceeds and there was no certainty that ING would ever obtain possession of the Trucks.

These are not the hallmarks of a sale conducted in the ordinary course of business.

[70] Finally, Brampton obtained the ING insurance proceeds through misrepresentation. In the proof of loss forms submitted to ING, Brampton represented that no one held a security or other interest in the Trucks apart from the named insured under the ING policies. This was untrue. Thus, the Transfer in favour of ING and Brampton's receipt of the ING insurance proceeds were accomplished by dishonest means. Normal commercial dealings with inventory by a leasing company in the course of the company's ordinary and usual business do not proceed on this basis.

[71] I would reject this ground of appeal.

(3) Section 25(1) of the PPSA

[72] ING also argues, for the first time on appeal, that s. 25(1) of the PPSA prevents GE's PMSIs in the Trucks from attaching to the collateral in ING's hands. Again, I disagree. For convenience, I again set out s. 25(1):

> **25.** (1) Where collateral gives rise to proceeds, the security interest therein,
>
> (a) *continues as to the collateral, unless the secured party expressly or impliedly authorized the dealing with the collateral free of the security interest*; and
>
> (b) extends to the proceeds. [Emphasis added.]

[73] In *Secured Transactions in Personal Property in Canada*, 2nd ed., looseleaf, (Scarborough: Carswell, 2003) at para. 9.01, Richard H. McLaren makes the following observation regarding the effect of s. 25(1):

> The negative implication of [s. 25(1)(a)] is that if the secured party authorized the disposition, then the acquiring party will take free of the secured party's claim to the collateral. In effect, the security agreement ceases to operate as to the collateral.

[74] ING accepts that GE's PMSIs extend to the proceeds of the Trucks. However, it submits that as the ING insurance proceeds were paid to Brampton, GE's claim for the proceeds must be advanced as a claim in Brampton's bankruptcy. ING also argues that GE's PMSIs do not "continue as to the collateral" within the meaning of s. 25(1)(a) because GE "expressly or impliedly authorized" Brampton to deal with the collateral: (i) by permitting Brampton to deal with insurance-related matters concerning the Trucks and to make insurance claims regarding stolen vehicles; and (ii) by classifying Brampton's vehicles as "inventory" in its PPSA registrations. I disagree.

[75] GE did not expressly authorize Brampton to sell or otherwise dispose of the Trucks. Nor do I think that such authorization was impliedly granted. While it is true that the terms of the CSAs authorized – indeed required – Brampton to place and maintain insurance on the Trucks, they also obliged Brampton to name GE as a beneficiary under the requisite insurance policies, "under a broad form of Secured Creditor Endorsement Clause". In addition, the CSAs contained an explicit title reservation clause in favour of GE. Unless and until the full amount owing to GE had been repaid, title to the Trucks remained with GE.

[76] These provisions of the CSAs, by which GE sought to protect its interests in the Trucks and to preserve its ownership of them until the amounts owing to it had been paid, belie the notion that GE authorized Brampton to dispose of the Trucks. On the contrary, until its payment obligations to GE had been satisfied, Brampton enjoyed only the right to quiet use and enjoyment of the Trucks for so long as it was not in default under the CSAs.

[77] Nor, on the facts of this case, do I accept that GE's description of the Trucks as "inventory" in its PPSA registrations constituted an implied authorization to Brampton to deal with the Trucks in any manner that Brampton saw fit. There is no evidence that GE knew that Brampton was leasing the Trucks with a view to eventually selling or otherwise disposing of them, that this was Brampton's intention, or that the sale of leased inventory formed part of Brampton's day-to-day or even occasional business activities. Indeed, this does not appear to have been suggested by Brampton even in its dealings with ING. The ING policies provided for "permission to rent or lease" the Trucks.

[78] I would not give effect to this ground of appeal.

(4) Concluding Observations

[79] I end with these observations. This case involves the balancing of the competing interests in collateral of two 'innocent' parties. GE took all necessary steps to perfect its PMSIs under the PPSA. It had no knowledge that the Trucks had been stolen until its own inquiries led to discovery of the thefts. Nor did it know of Brampton's misrepresentations to ING. ING had no involvement in the thefts or Brampton's

misrepresentations, and it did not know of GE's security interests in the Trucks until after it had paid the proceeds under the ING policies.

[80] On the other hand, measures were available to both parties that might have avoided this dispute. GE did not require that Brampton cause its third party lessees to name GE as an insured, a loss payee or a beneficiary under any third party insurance policy obtained on the Trucks. Nor did GE require Brampton to provide it with copies of any third party insurance policies. These options were available to GE. However, their success was dependent on the reliability of Brampton and its lessees.

[81] For its part, ING did not conduct any PPSA searches in this case. It defends this omission by pointing to what it describes as standard insurance industry practice: in reliance on s. 4(1)(c) of the PPSA, no PPSA searches are performed by insurers or insurance brokers prior to the issuance of automobile insurance policies. But, as I have said, the effect of s. 4(1)(c) of the PPSA is to relieve an insurer from the necessity of protecting its own interests in respect of an insurance policy by providing notice of those interests in the PPSA registry. Section 4(1)(c) does not insulate insurers from the PPSA-protected claims of third party secured creditors.

[82] And the means of ascertaining the existence of GE's PMSIs in the Trucks were readily available to ING by the simple device of conducting a PPSA search before issuing the ING policies, before paying the ING insurance proceeds, before requesting and receiving the Transfer from Brampton and, in the case of the 2005 Truck, before disposing of the insured collateral. Notice of GE's security interests was also provided in the used vehicle information packages available from the Ministry of Transportation. ING did not avail itself of any of these opportunities to determine if its interests would be subject to the protected priority position of another claimant. Unlike the preventative options available to GE, which I have described above, the measures available to ING to protect its interests were not dependent on the reliability of its insured or a third party.

[83] I note also that the potential existence of secured creditors with claims regarding the insured collateral was within ING's contemplation. The ING policies provided for the identification of lienholders and the protection of their interests on payment of the ING insurance proceeds. This record is silent as to what steps ING took, if any, to determine if secured claims existed in respect of the Trucks prior to settling Brampton's claim for indemnification under the ING policies.

[84] In these circumstances, I view it as unreasonable that a creditor in GE's position should lose its priority in secured collateral because it failed to foresee that its debtor would actively mislead its involved insurers. To hold otherwise would impose a protectionist obligation on GE and similarly situated secured lenders that could undermine normal good faith collateral financings.

[85] I therefore conclude that, as between GE and ING, the consequences of Brampton's misrepresentations must be borne by ING. It is ING, therefore, who must look to Brampton for satisfaction. This result is consistent with the proposition, which I endorse, that an insured or its named loss payee who has derived the benefit of an insurance policy, must make good to the insurer any loss occasioned to it by the insured's or the loss payee's lack of good faith or honesty.

IV. Disposition

[86] I would allow the appeal, set aside the order of the application judge, and declare that: (i) GE's PMSIs in the Trucks and their proceeds have priority over ING's salvage rights in the same vehicles; and (ii) GE is entitled to possession of the 2003 Truck and to the proceeds from the sale of the 2005 Truck. I would award GE its costs of this appeal on the partial indemnity scale, fixed in the amount of $17,000, inclusive of disbursements and G.S.T., and its costs of the proceeding before the application judge, fixed – as agreed by the parties – in the total amount of $15,000, inclusive of disbursements and G.S.T.

RELEASED:

"FEB 25 2009"
"RGJ"

"E.A. Cronk J.A."
"I agree R.G. Juriansz J.A."
"I agree J. MacFarland J.A."

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2002 ABCA 79
Alberta Court of Appeal

Northwest Equipment Inc. v. Daewoo Heavy Industries America Corp.

2002 CarswellAlta 397, 2002 ABCA 79, [2002] 6 W.W.R. 444, [2002] A.W.L.D. 198, [2002] A.J. No. 372, 112 A.C.W.S. (3d) 776, 1 Alta. L.R. (4th) 14, 266 W.A.C. 250, 299 A.R. 250, 3 P.P.S.A.C. (3d) 101

Northwest Equipment Inc., Appellant and Daewoo Heavy Industries America Corporation, Respondent

Fruman, Wittmann JJ.A., Brooker J. (ad hoc)

Heard: April 20, 2001
Judgment: March 19, 2002
Docket: Calgary Appeal 0019094

Counsel: *A.G. Bell*, for Appellant
K.T. Lenz, for Respondent

Subject: Corporate and Commercial; Insolvency; Contracts

Related Abridgment Classifications
For all relevant Canadian Abridgment Classifications refer to highest level of case via History.

Headnote

Personal property security --- Disposition of collateral by debtor — Sale in ordinary course of business

Secured creditor sold excavator to equipment dealer in B.C. and registered financing statement to secure purchase price — Dealer did not pay purchase price but sold excavator to Washington based U.S. company along with other assets as part of share purchase agreement without notice to creditor — Dealer represented that excavator was unencumbered — Excavator was type of property used in more than one jurisdiction and creditor should have registered security interest in Washington to maintain perfection under s. 7 of Personal Property Security Act (PPSA) — Dealer went bankrupt and creditor eventually seized excavator — On application by U.S. company for return of excavator, chambers judge held that U.S. company took excavator subject to security interest of creditor — Chambers judge held that creditor had not expressly or impliedly consented to sale of excavator, as required under s. 28(1)(a) of PPSA — U.S. company appealed — Appeal dismissed — Section 30(2) of PPSA did not apply as sale of excavator was not in ordinary course of dealer's business — U.S. company should have consulted B.C. personal property registry before buying equipment — Loss of perfection of creditor's security interest by failing to meet requirements of s. 7(3) of PPSA did not extinguish creditor's security interest — Purpose of perfection is to provide notice to third parties — U.S. company's interest in excavator remained subject to creditor's security interest while excavator was in U.S. — Personal Property Security Act, R.S.B.C. 1996, c. 359, ss. 7, 7(3), 28(1)(a), 30(2).

Personal property security --- Priority of security interest — Perfected versus unperfected interest

Secured creditor sold excavator to equipment dealer in B.C. and registered financing statement to secure purchase price — Dealer did not pay purchase price but sold excavator to Washington based U.S. company along with other assets as part of share purchase agreement without notice to creditor — Dealer represented that excavator was unencumbered — U.S. company leased excavator to third party and registered financing statement in Alberta — Dealer went bankrupt and creditor eventually seized excavator — On application by U.S. company for return of excavator, chambers judge held that U.S. company took excavator subject to security interest of creditor — Chambers judge held that creditor had not expressly or impliedly consented to sale of excavator, as required under s. 28(1)(a) of PPSA — U.S. company appealed

— Appeal dismissed — U.S. company did not perfect security interest in excavator by registering financing statement because agreement with third party was not security interest — U.S. company's interest in excavator remained subject to creditor's security interest — U.S. company did not have competing priority with creditor since it did not have security interest — U.S. company could have learned of creditor's secured interest by searching personal property registry in B.C. when it purchased excavator — No public policy or disclosure reason justified overriding s. 28(1)(a) by applying s. 35(1)(b) of PPSA to give U.S. company priority — Personal Property Security Act, R.S.B.C. 1996, c. 359, ss. 28(1)(a), 35(1)(b).

Personal property security --- Conflict of laws — Determining jurisdiction

Secured creditor sold excavator to equipment dealer in B.C. and registered financing statement to secure purchase price — Dealer did not pay purchase price but sold excavator to Washington based U.S. company along with other assets as part of share purchase agreement, without notice to creditor — Dealer represented that excavator was unencumbered — U.S. company leased excavator to third party and registered financing statement in Alberta — Dealer went bankrupt and creditor eventually seized excavator — On application by U.S. company for return of excavator, chambers judge held that U.S. company took excavator subject to security interest of creditor — Chambers judge held that creditor had not expressly or impliedly consented to sale of excavator — U.S. company appealed — Appeal dismissed — B.C. law applied because personal property security laws of B.C. and Alberta provided that perfection in this type of equipment was governed by law of jurisdiction where debtor was located when security interest attached — Debtor was located in B.C. when creditor acquired security interest — Section 7(2)(a) of Personal Property Security Act applied — Personal Property Security Act, R.S.B.C. 1996, c. 359, s. 7(2)(a).

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s. 7(2) — referred to

s. 7(2)(a) — considered

s. 7(2)(a)(ii) — referred to

s. 7(3) — considered

s. 12(1) — referred to

s. 19 — referred to

s. 20(a) — referred to

s. 20(b) — referred to

s. 20(c) — referred to

s. 24(1) — referred to

s. 25 — referred to

s. 28(1) — referred to

s. 28(1)(a) — considered

s. 30(2) — referred to

s. 35 — referred to

s. 35(1)(b) — considered

s. 35(1)(c) — referred to

s. 68(2) — referred to

s. 68(3) — referred to

APPEAL by U.S. owner of excavator from judgment which determined that equipment was purchased subject to security interest of creditor.

Fruman J.A.:

1 Both Daewoo Heavy Industries America Corporation, the secured party, and Northwest Equipment Inc., the owner, claim priority over an excavator. The equipment was originally purchased by a British Columbia company, and a security interest was granted to Daewoo in that province. But the excavator had a taste for travel. It was sold to Northwest, and without Daewoo's knowledge, moved from British Columbia to Washington State. Later, again without Daewoo's knowledge, it was relocated to Alberta. There it was leased to a third party, and was ultimately seized by Daewoo. Northwest contests the seizure and Daewoo's claim to the excavator.

2 This judgment attempts to unearth the rudiments of priorities, unperfected security interests and interjurisdictional rules. As the excavator's sojourn in each location gives rise to different legal issues and analyses, each jurisdiction will be examined separately. The unifying factor is the British Columbia *Personal Property Security Act*, R.S.B.C. 1996, c. 359.

3 British Columbia law applies because the personal property security laws of both British Columbia and Alberta provide that "the validity, perfection and effect of perfection or non-perfection of a security interest" in this type of equipment is governed by the law of the jurisdiction where the debtor was located when the security interest attached: (British Columbia *Personal Property Security Act*, *supra*, s. 7(2)(a); Alberta *Personal Property Security Act*, R.S.A. 2000, c. P-7, s. 7(2)(a)). The debtor was located in British Columbia when Daewoo acquired its security interest. Washington law has a similar, though not identical provision (*Uniform Commercial Code — Secured Transactions*, RCW 62A.9A-301(1)), but in any event, counsel did not provide expert evidence of Washington law, and relied on British Columbia law in respect of the Washington analysis. Therefore, British Columbia law generally applies to all three jurisdictions. Except as otherwise noted, references in this judgment are to the British Columbia statute, which is referred to as the *PPSA*.

British Columbia

4 Daewoo supplies heavy equipment, including excavators. Trainer Bros., a British Columbia corporation, sold and leased Daewoo's equipment, as well as heavy equipment manufactured by other companies.

5 In 1996, Daewoo began supplying equipment to Trainer Bros. in British Columbia. Trainer Bros. signed a security agreement, granting Daewoo a security interest in the inventory Daewoo had already supplied, as well as inventory to be supplied in the future. Among other clauses, the security agreement provided that Trainer Bros. would not sell any of the inventory supplied by Daewoo without Daewoo's written consent, unless the sale was in the ordinary course of Trainer Bros.' business. Trainer Bros. also undertook to notify Daewoo about any change in the location of the equipment (AB IV at 363). On September 25, 1996, Daewoo registered a financing statement at the British Columbia Personal Property Registry.

6 In 1997, Daewoo sold Trainer Bros. the excavator that is the subject of this dispute. The purchase price of approximately US$150,000 was due on November 30, 1997, but was never paid. This was one of many defaults under the security agreement. The total outstanding debt owed to Daewoo is approximately US$1.5 million. Trainer Bros. has since declared bankruptcy.

7 Northwest is a Washington-based corporation that sells and leases construction equipment. In May 1998, prior to Trainer Bros.' bankruptcy, Northwest purchased the excavator from it as part of a larger asset purchase. According to Northwest, Trainer Bros.' negotiator, William Trainer, represented that the excavator was unencumbered (AB III at 149). The misrepresentation was repeated in writing in the Bill of Sale (AB V at 402). Although it was Northwest's usual practice to conduct encumbrance searches when it purchased earthmoving equipment, it did not search the British Columbia Personal Property Registry to determine if any security interests were registered against the excavator (AB III at 149-50).

8 Under the terms of the sale, Northwest was to receive seven pieces of equipment and a $300,000 loan from Trainer Bros., and Trainer Bros. was to receive 49% of the shares of Northwest. The loan was never made and the shares were never issued. Trainer Bros.' receiver eventually assigned all claims against Northwest to William Trainer's sister-in-law.

9 Northwest contends that the sale of the excavator was in the ordinary course of Trainer Bros.' business, and therefore, it took the excavator free from Daewoo's security interest. A master in chambers agreed. But on appeal *de novo* to the Court of Queen's Bench, a chambers judge decided that the sale of the excavator and other machinery for a minority interest in a U.S. corporation was not in the ordinary course of Trainer Bros.' business (AB I at 34). The chambers judge also decided that Daewoo had not expressly or impliedly consented to the sale of the excavator (AB I at 39). Accordingly, Northwest took the excavator subject to Daewoo's security interest.

10 Northwest appeals both findings.

Ordinary Course of Business

11 Section 28(1)(a) [1] of the *PPSA* states the general rule that a security interest continues if the collateral is dealt with. It is "not affected by a sale and can be enforced against the buyer": R. C. C. Cuming and R. J. Wood, *British Columbia Personal Property Security Act Handbook*, 4th ed. (Scarborough: Carswell, 1998) at 182. The section is a statutory formulation of the *nemo dat* rule, a common law and common sense principle that one cannot give away more than one possesses. See D. A. Dukelow & B. Nuse, eds., *Dictionary of Canadian Law*, 2nd ed. (Scarborough: Carswell, 1995), *s.v. "nemo dat quod non habet"*.

12 Daewoo's security interest in the excavator attached when Trainer Bros. took possession of it in 1997. [2] Because a financing statement had already been registered, Daewoo then had a perfected security interest in the excavator. [3] The security interest was still perfected when Northwest purchased the excavator in 1998. Applying s. 28(1)(a), Trainer Bros. could not convey a greater interest in the excavator to Northwest than Trainer Bros. actually had. Because Trainer Bros.' interest was subject to Daewoo's perfected security interest, Northwest's interest would be similarly encumbered.

13 But s. 28(1)(a) does not always apply. In certain circumstances the *PPSA* has specifically replaced the *nemo dat* rule, permitting a transferee to receive greater rights in property than the transferor possessed. See *Giffen (Re)*, [1998] 1 S.C.R. 91 (S.C.C.) and *Donaghy v. CSN Vehicle Leasing* (1992), 132 A.R. 155 (Alta. Q.B.) (trustee in bankruptcy obtained better title to a leased good than the bankrupt possessed by virtue of s. 20((b)). Sales in the ordinary course of business under s. 30(2) [4] and transfers with consent under s. 28(1)(a) are exceptions to the *nemo dat* rule.

14 Under s. 30(2), a buyer of goods sold in the ordinary course of the seller's business takes the goods free from any perfected or unperfected security interest given by the seller. Its purpose "is to avoid disruption to commerce and injustice to unsuspecting ordinary course buyers which would otherwise result if such buyers were required in every case to conduct a search of the Personal Property Registry before buying goods": Cuming and Wood, *supra*, at 213. The focus is on commercial practicality: *Fairline Boats Ltd. v. Leger* (1980), 1 P.P.S.A.C. 218 (Ont. H.C.), at 220-21. The ordinary course exception applies whether or not the buyer knew of the security interest, and even though the security agreement limited the seller's rights to dispose of the goods. The exception does not apply if the buyer was aware that the transaction was in breach of the security agreement.

15 Accordingly, if Trainer Bros. sold the excavator in the ordinary course of its business, Northwest would acquire it free from Daewoo's security interest. Sales in the ordinary course of business are usually "carried out under normal terms and consistent with general commercial practices": Cuming and Wood, *supra*, at 215. The chambers judge decided the sale of equipment to Northwest was sufficiently unusual that it was outside the ordinary course of Trainer Bros.' business. He considered several factors, including:

- the transaction was a component of a share purchase arrangement, not a cash sale; Trainer Bros. ordinarily sold and leased inventory for cash;

• the form of transaction — shares and a loan back to the purchaser — was unusual; there had been no prior transactions by Trainer Bros. of a similar type;

• the purchaser was a dealer, not a construction company; Trainer Bros. ordinarily sold products to end users;

• the sale, which involved one-quarter of Trainer Bros.' inventory, constituted a comparatively large portion of overall sales;

• the transaction was not advertised;

• the transaction was concluded on the eve of insolvency; and

• the consideration was never tendered.

16 Because the chambers judge heard the appeal from the master's order *de novo*, this court reviews the chambers judge's decision as a judgment of a court of first instance. Provided a first instance judge considers the appropriate factors in deciding whether a transaction is in the ordinary course of business, a reviewing court will defer to the judge's findings: *369413 Alberta Ltd. v. Pocklington* (2000), 271 A.R. 280 (Alta. C.A.), at 289. The factors considered by the chambers judge were appropriate and provide ample evidence upon which he could conclude that the sale of the equipment by Trainer Bros. to Northwest was outside Trainer Bros.' ordinary course of business. This transaction was sufficiently unusual that Northwest should have consulted the British Columbia Personal Property Registry before buying the equipment.

Consent

17 The *PPSA* contains a second exception that permits a purchaser to acquire goods free from a secured charge. Under s. 28(1)(a), a security interest in collateral does not continue if the secured party expressly or impliedly authorized the transfer.

18 Northwest alleges that Daewoo consented to the sale of the excavator because Trainer Bros. discussed the restructuring of its business operations with Daewoo. The chambers judge decided that the discussions did not provide adequate or accurate disclosure of the arrangement between Trainer Bros. and Northwest (AB I at 37). Consequently, Daewoo neither expressly nor impliedly authorized the transaction. In reaching this conclusion, he considered the following factors:

• the corporate restructuring proposal contemplated revenue from sales, but the consideration for the actual transaction was a share deal, with no cash compensation;

• the proposal contemplated a location in Abbotsford, British Columbia, and did not mention transferring the equipment to Washington; and

• the proposal contemplated a rental arrangement, not an outright sale.

19 Additional evidence before the trial judge included:

• the affidavit evidence of Daewoo's Vice President and Regional Sales Manager specifically denied that Daewoo consented to or approved the transaction;

• no evidence of any written consent was tendered; and

• Northwest failed to establish that Daewoo knew of the transaction until some months after it occurred.

22 The chambers judge correctly noted that Northwest had the onus to prove Daewoo expressly or impliedly authorized the transaction, but was not satisfied on the evidence that Northwest had met this onus (AB I at 39). Appellate courts defer to fact findings of courts of first instance, even when they are based on conflicting affidavit evidence: *Toneguzzo-Norvell (Guardian ad litem of) v. Burnaby Hospital*, [1994] 1 S.C.R. 114 (S.C.C.), at 121. The chambers judge had ample evidence on which to conclude that Daewoo had not consented to the transaction.

23 In summary, Trainer Bros. did not sell the excavator to Northwest in the ordinary course of its business, nor did Daewoo expressly or impliedly authorize the sale. Neither the ordinary course exception in s.30(2) nor the consent exception in s. 28(1)(a) apply. Therefore, Northwest acquired the excavator in British Columbia subject to Daewoo's perfected security interest.

Washington

24 Northwest agreed to purchase the equipment from Trainer Bros. in early May, 1998. On May 20, 1998, the excavator was moved from British Columbia to Washington. Trainer Bros. did not advise Daewoo about the relocation of the excavator, although it was required to do so under Daewoo's security agreement. As a result, Daewoo did not learn of the transfer until September, 1998. On September 22, 1998, it registered its security interest in Washington, and immediately attempted to repossess the excavator in summary proceedings. The Washington court denied Daewoo's summary application, instead referring the matter to a full evidentiary hearing (AB III at 113-14).

25 Northwest asserts that the transfer of the excavator to Washington defeated Daewoo's security interest because it became unperfected through late registration in Washington. The chambers judge made a general finding that the transfer of the excavator to Washington did not affect Daewoo's security interest.

Perfection

26 Northwest's arguments in this section, and in the Alberta section that follows, are based upon a misunderstanding of the consequences that flow from a loss of perfection. To give these arguments context, it is necessary to delve into the purpose of perfection. Perfection is nothing more than a method of providing disclosure of prior security interests to third parties to enable them to protect themselves against loss. With some types of property, such as share certificates, it is best achieved by possession of the encumbered property. [5] But perfection is usually accomplished by registering a financing statement in a personal property registry. [6] A prudent third party who conducts a personal property registry search will be able to determine whether the property is encumbered, and decide what steps to take to prevent loss.

27 As a general rule, the validity and perfection of a security interest are governed by the law of the jurisdiction in which the goods were situated at the time the security interest attached, [7] and that is the location in which a third party would conduct its search. However, the *PPSA* recognizes that certain types of property are frequently used in more than one jurisdiction. Because the goods move around, a third party who wishes to determine whether any encumbrances have been registered against them cannot rely on their current location as the appropriate jurisdiction in which to search. Instead, the *PPSA* provides that the validity of security interests in these types of itinerant property is governed by the law of the jurisdiction in which the debtor, not the property, was located at the time the security interest attached. [8] A third party who wishes to determine whether any security interests have been registered against this kind of property would therefore conduct searches in the jurisdiction in which the debtor is located.

28 But occasionally debtors move, and sometimes they transfer encumbered property to parties located in other jurisdictions. In order to fully protect third parties, who "would reasonably assume that the public records of the jurisdiction where the transferee is located would disclose the existence of the security interest given by the debtor", security interests must also be publicly disclosed in the new jurisdiction: Cuming and Wood, *supra*, at 91. See also *Canadian Imperial Bank of Commerce v. A.K. Construction (1988) Ltd.* (1996), 186 A.R. 1 (Alta. Master), at 6; aff'd. (1998), 223 A.R. 115 (Alta. C.A.). Under s. 7(3), [9] a transfer by a debtor of an interest in these types of itinerant property to someone located in another jurisdiction triggers a perfection requirement in the new jurisdiction. If the security interest is perfected in the new jurisdiction within the time deadlines set out in the section, it is deemed to be continuously perfected in British Columbia, despite the delay in registration. If it is not, the security interest becomes unperfected.

29 The perfection requirement in s. 7(3) applies in this case if the excavator (i) is the type of goods that are "normally used in more than one jurisdiction" and (ii) is "inventory leased or held for lease" by Trainer Bros., the original debtor (s. 7(2)). The

first part of the test is a generic categorization of various types of goods; the second part is specific to Trainer Bros.' actual use of the excavator.

30 The *PPSA* does not provide additional clarification about what goods "are of a type that are normally used in more than one jurisdiction". In *Gimli Auto Ltd. v. Canada Campers Inc. (Trustee of)* (1998), 219 A.R. 166 (Alta. C.A.), at 169, the court noted the "paucity of authority in Canada" and suggested that the term should be interpreted in a manner consistent with the United States Uniform Commercial Code, which uses similar wording. Article 9 of the U.C.C. contains a description of "goods of a type which are normally used in more than one jurisdiction", including "road building and construction machinery [...] and the like" (s. 9-103(3)(a)). The excavator clearly fits within this category. Accordingly, it is the type of property that is used in more than one jurisdiction and, because the excavator was inventory held for lease by Trainer Bros., it meets the threshold requirements for the application of s. 7.

31 Trainer Bros. transferred the excavator to Northwest, a Washington-based company, and "a person located in another jurisdiction" under s. 7(3). In order for Daewoo's security interest in the excavator to remain continuously perfected in British Columbia, it had to perfect its interest in Washington within the time set out in s. 7(3). Daewoo had at most 60 days in which to register but did not meet this deadline. Accordingly, Daewoo's security interest became unperfected in British Columbia.

Loss of Perfection

32 Northwest contends that the loss of perfection had a dramatic impact on Daewoo's previously registered security interest. It alleges that by taking possession of the excavator Northwest perfected a security interest that had priority over Daewoo's unperfected security interest. Alternatively, it argues that when a security interest becomes unperfected, a prior perfected charge is either extinguished entirely, or becomes invalid against parties who previously took the property subject to the perfected security interest.

33 Getting to the bottom of the first argument, Northwest did not acquire a security interest when it took possession of the excavator. A "security interest" is "an interest in goods [...] that secures payment or performance of an obligation" (s. 1(1)). When Northwest purchased the excavator from Trainer Bros., it acquired an ownership interest in the collateral,[10] not a competing security interest. There is no issue of priority between Northwest and Daewoo.

34 Northwest incorrectly asserts that a loss of perfection extinguishes a security interest. Perfection is a method of third party notification, not a precondition to validity. The *PPSA* states that, subject to its provisions, "a security agreement is effective according to its terms" (s. 9). "[Lack] of perfection does not affect the legal quality of the transaction but results in a lesser bundle of statutory rights under the Act": R. H. McLaren, *Secured Transactions in Personal Property in Canada*, 2nd ed. (Toronto: Carswell, 1989) at 5-149. See also *Burton v. Petrone, Hatherly, Hornak & Associates* (1985), 53 O.R. (2d) 110 (Ont. H.C.), at 114; *Couiyk v. Couiyk*, [1999] B.C.J. No. 2737 (B.C. S.C.) at para. 10.

35 The *PPSA* provides a few specific instances in which unperfected security interests are ineffective against specified parties (s. 20(b)) or subordinate to other interests that arise at the time the security is unperfected (s. 20(a); s. 20(c)). Even in these special circumstances, the *PPSA* does not extinguish unperfected charges. In fact, it contemplates enforcement of both perfected and unperfected security interests, and provides for priorities between them (s. 35(1)(b) and (c)). Accordingly, neither failure to initially perfect a security interest nor a subsequent loss of perfection extinguishes a security interest.

36 Northwest's argument that a loss of perfection invalidates existing priorities is equally flawed. As a general rule, a security interest continues if the collateral is dealt with (s.28(1)(a)). Sales in the ordinary course of business and transfers with consent are exceptions but, as explained above, they are not applicable in this case.

37 The *PPSA* contains another exception to the *nemo dat* rule that applies to an acquisition of goods that are subject to an unperfected security interest. A transferee for value who acquires an interest other than a security interest in goods, without knowledge of the prior security interest and before it is perfected, acquires the goods free from the unperfected security interest (s. 20(c)).[11]

38 Section 20(c) contains a number of conditions, each of which must be met at the time the interest is acquired. In particular, the transferee must acquire the goods before the security interest is perfected. If the security interest has already been perfected, s. 20(c) does not apply and the prior security interest retains its priority. The transferee takes the goods subject to it under s. 28(1)(a); a subsequent loss of perfection does not improve the transferee's title. See *Bank of Montreal v. Kalatzis* (1984), 37 Sask. R. 300 (Sask. Q.B.); Cuming and Wood, *supra*, at 157.

39 In this case, Northwest acquired the excavator after Daewoo had perfected its security interest. The exception in s. 20(c) does not apply. Northwest acquired the excavator subject to Daewoo's security interest, and continues to hold it subject to that interest despite the subsequent loss of perfection.

40 This result is consistent with the purpose of perfection. When Northwest acquired the excavator, Trainer Bros. was located in British Columbia. To protect itself, Northwest should have conducted a search in the British Columbia Personal Property Registry. Had it done so, it would have become aware of Daewoo's perfected security interest. The transfer of the excavator to Washington triggered a perfection requirement, not to protect Northwest, but to provide disclosure to third parties dealing with Northwest.

41 In summary, a loss of perfection neither extinguishes a security interest nor invalidates existing priorities. Lack of perfection might, in some circumstances, lead to a priority battle with a third party who acquired a security interest while the earlier interest was unperfected. It does not improve the title of a party who acquired the goods subject to the perfected charge. Accordingly, while the excavator was in Washington, Northwest's interest in it remained subject to Daewoo's security interest.

Alberta

42 Northwest hired Solar Heavy Equipment Rental Ltd. as its Alberta leasing agent. Solar's president, William Trainer, was the former employee of Trainer Bros. who originally negotiated the sale of the excavator to Northwest. In May 1999, Northwest moved the excavator into Alberta and, with Solar's assistance, leased it to Win Management. On May 13, 1999, Northwest registered a financing statement in the Alberta Personal Property Registry.

43 Once again, Daewoo was not notified of the transfer. It learned that the excavator had been relocated in January, 2000, and registered its security interest at the Alberta Personal Property Registry on January 18, 2000. Daewoo seized the excavator on February 4, 2000. Northwest contested Daewoo's claim to the excavator and made an application for its return. That application was dismissed by a Queen's Bench judge and is the subject of this appeal.

44 Northwest contends that it perfected a security interest in the excavator by registering the financing statement. It argues that Daewoo's security interest was unperfected at that time, and therefore its perfected security interest has priority. The chambers judge decided that Northwest could not "perfect an alleged security interest in the property by leasing the goods [...] to Win Management and registering as a secured party under the Alberta PPSA" (AB I at 40). He held that Daewoo had priority over the excavator, subject only to the security interest of Win Management under the lease with Northwest (*id.*)

Security Interest

45 Northwest's priority argument is based on its assertion that it perfected a security interest in the excavator by registering a financing statement. Northwest provides no analysis to support this conclusion; Daewoo argues that because the Win Management lease is for a term of less than one year, it did not create a security interest. As Win Management, the debtor, is located in Alberta, Alberta law applies to a determination whether Northwest had a perfected security interest in Alberta. [12]

46 Registration of a financing statement does not perfect anything unless the underlying agreement created a security interest. The Alberta *Personal Property Security Act*, *supra*, restricts its application to transactions that secure payment or performance of an obligation, including a lease and a conditional sale, regardless of their form. [13] It is also deemed to apply to a lease for a term of more than one year, even if it does not secure payment or performance of an obligation. [14] The definition of "security

interest" incorporates these concepts. [15] A "security agreement" is one "that creates or provides for a security interest" (s. 1(1)(ss)).

47 The issue, then, is whether the agreement between Northwest and Win Management created a security interest that could be perfected by registration. Because "a lease for a term of more than one year" [16] is deemed to create a security interest, the term of the agreement is the logical starting point for this analysis.

48 The Win Management agreement is entitled "Equipment Rental Agreement" with the words "Option To Purchase" handwritten beside the printed title (AB V at 436). The agreement contains 18 brief clauses. The term is for a "guaranteed rental period" of "monthly" (*id.* at 439). There is no provision for the lease to continue from month to month; for renewal, either automatic or on notice; or for termination by the lessee. The lease provides that overdue rental payments bear no interest and that payments are "due at end of season"(*id.* at 437). "Season" is not defined, but is bound to be less than a year. Given the rental payment provision, and the absence of a renewal provision, this lease is most likely a lease for a single season that is less than a year. Such a lease could still qualify as a security interest if "the lessee's possession extends for more than one year" (s. 1(3)). However, Win Management's actual possession was interrupted by Daewoo's seizure. Accordingly, the agreement is not a "lease for a term of more than one year" and did not create a security interest.

49 But it is necessary to dig deeper. Even a short-term lease may in substance create a security interest if, for example, it contains an option to purchase that can be construed to be a conditional sale agreement. Many factors may be considered in characterizing an agreement, no less than 16 of which are identified in *Bronson, Re* (1995), 34 C.B.R. (3d) 255 (B.C. Master), at 262-63; aff'd (1996), 39 C.B.R. (3d) 33 (B.C. S.C.). One of the most important indicators is the option price. An option price that is nominal or less than market value suggests that the lessee pays, as rental, the lessor's capital investment plus a credit charge. In that situation the transaction is really a conditional sale and the agreement creates a security interest. An option price that is close to fair market value suggests that the lease payments are really rental payments for use of the equipment, not payments towards the purchase price. In that case the lease is a true lease, not a security agreement. See Cuming and Wood, *supra*, at 35-36; *Bronson, Re*, 34 C.B.R. (3d) at 259.

50 The option to purchase in the Win Management agreement is succinct, to say the least. It consists of the handwritten words "100% of rental pd to apply againest [*sic*] purchase" (AB V at 440). The purchase price for the excavator, option exercise price and term of the option are neither specified nor calculable. The other provisions of the agreement are too sparse to be of assistance.

51 Although Northwest and Win Management filed affidavits in these proceedings, they provided no additional evidence that would assist in construing the substance of the option to purchase. The only evidence is the written agreement and it does not support the creation of a security interest.

52 As Northwest does not have a security interest in the excavator, it does not have a competing priority with Daewoo, and its argument fails. But even if Northwest had a perfected security interest, and even if that interest were perfected at a time that Daewoo's security interest were unperfected, Northwest would not have priority over the excavator.

Competing Priorities

53 Northwest's claim to priority over the excavator on the basis of a competing security interest breaks new ground. It is based on s. 35(1)(b) [17] of the *PPSA*, which ranks a perfected security interest ahead of an unperfected security interest. Section 35 contains residual priority rules that only apply when the *PPSA* "does not provide another method for determining priority between security interests." Under s. 28(1)(a), Northwest acquired its interest in the excavator subject to Daewoo's security interest. Northwest asserts that the residual priority rules in s. 35(1)(b) should override s.28(1)(a), catapulting Northwest's interest ahead of Daewoo's.

54 Perfection is based on public policy that requires disclosure of the existence of security interests to "[give] third parties the ability to take the necessary prophylactic measures when dealing with debtors to avoid loss that would otherwise result from

the application of the principle of *nemo dat quod non habet*": Cuming and Wood, *supra* at 145. Perfection may therefore be relevant to a determination of priorities between third parties with competing claims.

55 But Northwest is not a third party that would need protection through additional disclosure. It could have learned of Daewoo's secured interest by checking the British Columbia Personal Property Registry when it purchased the excavator. Moreover, by the time Northwest registered in Alberta, it had actual knowledge of Daewoo's security interest. In the Washington proceedings seven months earlier, Northwest was not only aware of Daewoo's claim, but took the position that Daewoo had an unperfected security interest in the excavator (AB III at 82).

56 No public policy or disclosure reason justifies overriding s. 28(1)(a). And there is also the question of commercial practicality. Because secured transactions do not occur in an economic vacuum, the *PPSA* imports a requirement for commercial reasonableness and good faith. [18] Technical compliance will not suffice if the result is not commercially reasonable, judged by "what can reasonably be expected of participants in the market in which the particular transaction took place": Cuming and Wood, *supra*, at 436.

57 Market participants want certainty. They do not favour leap-frogging priorities. Creditors would be hard pressed to lend money if a valid charge could be defeated by a surreptitious removal of the collateral to another jurisdiction, and the creation by the collateral holder of a secured interest in its own favour. Applying s. 35(1)(b) to give Northwest priority in these circumstances would not be commercially reasonable.

58 In summary, even if Northwest had a perfected security interest in Alberta, the priority dispute between Daewoo and Northwest would be determined by s.28(1)(a) of the *PPSA* and there would be no need to resort to the residual priority rules in s. 35(1)(b). When Northwest purchased the excavator, it took it subject to Daewoo's perfected security interest. Neither a loss of perfection nor the subsequent creation by Northwest of a perfected security interest in its favour would change that.

Conclusion

59 Northwest has not shown any error in the chambers judge's decision. The appeal is dismissed.

***Wittmann J.A.*:**

I concur.

***Brooker J.* (ad hoc):**

I concur.

Appeal dismissed.

Footnotes

1 28(1) Subject to this Act, if collateral is dealt with or otherwise gives rise to proceeds, the security interest

(a) continues in the collateral unless the secured party expressly or impliedly authorizes the dealing, and

(b) extends to the proceeds,

[...]

2 12(1) A security interest, including a security interest in the nature of a floating charge, attaches when

(a) value is given,

(b) the debtor has rights in the collateral, and

(c) except for the purpose of enforcing rights between the parties to the security agreement, the security interest becomes enforceable under section 10,

[...]

3 19 A security interest is perfected when

(a) it has attached, and

(b) all steps required for perfection under this Act have been completed, regardless of the order of occurrence.

4 30(2) A buyer or lessee of goods sold or leased in the ordinary course of business of the seller or lessor takes free of any perfected or unperfected security interest in the goods given by the seller or lessor or arising under section 28 or 29, whether or not the buyer or lessee knows of it, unless the buyer or lessee also knows that the sale or lease constitutes a breach of the security agreement under which the security interest was created.

5 24(1) Subject to section 19, possession of the collateral by the secured party, or on the secured party's behalf by another person, perfects a security interest in

(a) chattel paper,

(b) goods,

(c) an instrument,

(d) a security,

(e) a negotiable document of title, and

(f) money

unless possession is a result of seizure or repossession.

6 25 Subject to section 19, registration of a financing statement perfects a security interest in collateral.

7 5(1) Subject to sections 6 to 8, the validity, perfection and effect of perfection or non-perfection of

(a) a security interest in goods,

[...]

is governed by the law of the jurisdiction where the collateral is located when the security interest attaches.

8 7 (2) The validity, perfection and effect of perfection or non-perfection of

(a) a security interest in

[...]

(ii) goods [...] that are of a type that are normally used in more than one jurisdiction, if the goods are equipment or are inventory leased or held for lease by the debtor to others,

[...]

is governed by the law, including the conflict of laws rules, of the jurisdiction where the debtor is located when the security interest attaches.

9 7(3) If the debtor relocates to another jurisdiction or transfers an interest in the collateral to a person located in another jurisdiction, a security interest perfected in accordance with the law applicable as provided in subsection (2) continues perfected in British Columbia if it is perfected in the other jurisdiction

(a) not later than 60 days after the day the debtor relocates or transfers an interest in the collateral to a person located in the other jurisdiction,

(b) not later than 15 days after the day the secured party has knowledge that the debtor has relocated or has transferred an interest in the collateral to a person located in the other jurisdiction, or

(c) before the date that perfection ceases under the law of the first jurisdiction,

whichever is the earliest.

10 1(1) In this Act:

[...]

"collateral" means personal property that is subject to a security interest;

11 20 A security interest

(c) in [...] goods is subordinate to the interest of a transferee who

(i) acquires an interest under a transaction that is not a security agreement,

(ii) gives value, and

(iii) acquires the interest without knowledge of the security interest and before the security interest is perfected.

12 The Alberta *Personal Property Security Act*, *supra*, provides:

7(2) The validity, perfection and effect of perfection or non-perfection of

(a) a security interest in

[...]

(ii) goods that are of a kind that are normally used in more than one jurisdiction, if the goods are equipment or are inventory leased or held for lease by the debtor to others

[...]

must be governed by the law, including the conflict of laws rules, of the jurisdiction where the debtor is located at the time the security interest attaches.

13 3(1) Subject to section 4, this Act applies to

(a) every transaction that in substances creates a security interest, without regard to its form [...], and

(b) without limiting the generality of clause (a), a chattel mortgage, conditional sale, floating charge, pledge, trust indenture, trust receipt, assignment, consignment, lease, trust and transfer of chattel paper where they secure payment or performance of an obligation.

[...]

14 3(3) Subject to sections 4 and 55, this Act applies to

[...]

(b) a lease of goods for a term of more than one year,

[...]

that does not secure payment or performance of an obligation.

15 1(1) In this Act,

[...]

(tt) "security interest" means

(i) an interest in goods [...] that secures payment or performance of an obligation [...]

(ii) the interest of [...]

(C) a lessor under a lease for a term of more than one year,

whether or not the interest secures payment or performance of the obligation;

16 1(1) In this Act,

[...]

(z) "lease for a term of more than one year" includes

(i) a lease for an indefinite term even though the lease is determinable by one or both parties within one year after its execution,

(ii) subject to subsection (3), a lease initially for a term of one year or less than one year if the lessee, with the consent of the lessor, retains uninterrupted, or substantially uninterrupted, possession of the leased goods for a period in excess of one year after the date the lessee first acquired possession of the goods, and

(iii) a lease for a term of one year or less that is automatically renewable or that is renewable at the option of one of the parties, or by agreement, for one or more terms, the total of which, including the original term, may exceed one year,

[...]

17 35(1) If this Act does not provide another method for determining priority between security interests,

[...]

(b) a perfected security interest has priority over an unperfected security interest,

[...]

18 68(2) All rights, duties or obligations arising under a security agreement, this Act or any other law applicable to security agreements or security interests must be exercised or discharged in good faith and in a commercially reasonable manner.

(3) A person does not act in bad faith merely because the person acts with knowledge of the interest of some other person.

End of Document

4

Personal Property Security Act (Ontario)

25. (1) Where collateral gives rise to proceeds, the security interest therein,

(a) continues as to the collateral, unless the secured party expressly or impliedly authorized the dealing with the collateral free of the security interest; and

(b) extends to the proceeds.

(2) Where the security interest was perfected by registration when the proceeds arose, the security interest in the proceeds remains continuously perfected so long as the registration remains effective or, where the security interest is perfected with respect to the proceeds by any other method permitted under this Act, for so long as the conditions of such perfection are satisfied.

(3) A security interest in proceeds is a continuously perfected security interest if the interest in the collateral was perfected when the proceeds arose.

(4) If a security interest in collateral was perfected otherwise than by registration, the security interest in the proceeds becomes unperfected ten days after the debtor acquires an interest in the proceeds unless the security interest in the proceeds is perfected under this Act.

(5) Where a motor vehicle, as defined in the regulations, is proceeds, a person who buys or leases the vehicle as consumer goods in good faith takes it free of any security interest therein that extends to it under clause (1) (b) even though it is perfected under subsection (2) unless the secured party has registered a financing change statement that sets out the vehicle identification number in the designated place.

28. (1) A buyer of goods from a seller who sells the goods in the ordinary course of business takes them free from any security interest therein given by the seller even though it is perfected and the buyer knows of it, unless the buyer also knew that the sale constituted a breach of the security agreement.

(1.1) Subsection (1) applies whether or not,

(a) the buyer took possession of the goods;

(b) the seller was in possession of the goods at any time;

(c) title to the goods passed to the buyer; or

(d) the seller took a security interest in the goods.

(1.2) Despite subsection (1.1), subsection (1) does not apply if the goods were not identified to the contract of sale.

(1.3) For the purposes of subsection (1.2), goods are identified to the contract of sale when they are,

(a) identified and agreed upon by the parties at the time the contract is made; or

(b) marked or designated to the contract,

(i) by the seller, or

(ii) by the buyer, with the seller's consent or authorization.

(2) A lessee of goods from a lessor who leases the goods in the ordinary course of business holds the goods, to the extent of the lessee's rights under the lease, free from any security interest therein given by the lessor even though it is perfected and the lessee knows of it, unless the lessee also knew that the lease constituted a breach of the security agreement.

(2.1) Subsection (2) applies whether or not,

(a) the lessee took possession of the goods; or

(b) the lessor was in possession of the goods at any time.

(2.2) Despite subsection (2.1), subsection (2) does not apply if the goods were not identified to the contract of lease.

(2.3) For the purposes of subsection (2.2), goods are identified to the contract of lease when they are,

(a) identified and agreed upon by the parties at the time the contract is made; or

(b) marked or designated to the contract,

(i) by the lessor, or

(ii) by the lessee, with the lessor's consent or authorization.

(3) A purchaser of chattel paper who takes possession of it in the ordinary course of business and gives new value has priority over any security interest in it,

(a) that was perfected by registration if the purchaser did not know at the time of taking possession that the chattel paper was subject to a security interest; or

(b) that has attached to proceeds of inventory under section 25, whatever the extent of the purchaser's knowledge.

(4) A purchaser of collateral that is an instrument or negotiable document of title has priority over any security interest therein perfected by registration or temporarily perfected under section 23 or 24 if the purchaser,

(a) gave value for the interest purchased;

(b) purchased the collateral without knowledge that it was subject to a security interest; and

(c) has taken possession of the collateral.

(5) Where a motor vehicle, as defined in the regulations, is sold other than in the ordinary course of business of the seller and the motor vehicle is classified as equipment of the seller, the buyer takes it free from any security interest therein given by the seller even though it is perfected by registration unless the vehicle identification number of the motor vehicle is set out in the designated place on a registered financing statement or financing change statement or unless the buyer knew that the sale constituted a breach of the security agreement.

(6) A purchaser of a security, other than a secured party, who,

(a) gives value;

(b) does not know that the transaction constitutes a breach of a security agreement granting a security interest in the security to a secured party that does not have control of the security; and

(c) obtains control of the security,

acquires the security free from the security interest.

(7) A purchaser referred to in subsection (6) is not required to determine whether a security interest has been granted in the security or whether the transaction constitutes a breach of a security agreement.

(8) An action based on a security agreement creating a security interest in a financial asset, however framed, may not be brought against a person who acquires a security entitlement under section 95 of the Securities Transfer Act, 2006 for value and did not know that there has been a breach of the security agreement.

(9) A person who acquires a security entitlement under section 95 of the Securities Transfer Act, 2006 is not required to determine whether a security interest has been granted in a financial asset or whether there has been a breach of the security agreement.

(10) If an action based on a security agreement creating a security interest in a financial asset could not be brought against an entitlement holder under

subsection (8), it may not be brought against a person who purchases a security entitlement, or an interest in it, from the entitlement holder.

69. For the purposes of this Act, a person learns or knows or has notice or is notified when service is effected in accordance with section 68 or the regulations or when,

(a) in the case of an individual, information comes to his or her attention under circumstances in which a reasonable person would take cognizance of it;

(b) in the case of a partnership, information has come to the attention of one or more of the general partners or of a person having control or management of the partnership business under circumstances in which a reasonable person would take cognizance of it;

(c) in the case of a corporation, other than a municipal corporation or local board thereof, information has come to the attention of a senior employee of the corporation with responsibility for matters to which the information relates under circumstances in which a reasonable person would take cognizance of it.

Court File No. CV-14-10766-00CL

TRISURA GUARANTEE INSURANCE COMPANY - and - **EBERSOLE EXCAVATING INC. AND D&S RAILWAY CONSTRUCTION INC.**

Applicant

Respondents

ONTARIO
SUPERIOR COURT OF JUSTICE
(COMMERCIAL LIST)

PROCEEDINGS COMMENCED AT TORONTO

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