

SECURITY UNDER SECTIONS 177 AND 178 OF THE BANK ACT

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Sections 177 and 178 of the Bank Act provide Canadian chartered banks with special mechanisms for taking security interests in the assets of business borrowers. Section 178, the more familiar of the two provisions, allows a bank to extend inventory financing to a broad range of manufacturers of goods, producers of primary products, and dealers in those goods and products. Section 177, of somewhat more recent origin, provides for the financing of those engaged in extracting hydrocarbons and minerals. Both sections were expanded significantly in the 1980 revisions to the Bank Act. In this article, the author examines the provisions of sections 177 and 178 and discusses in turn the creation, enforcement and priorities of the special security arrangements that are available to a bank under those sections.

Les articles 177 et 178 de la Loi sur les banques offrent aux banques à charte du Canada des mécanismes spéciaux qui leur permettent de se garantir sur les biens des emprunteurs commerciaux. L'article 178, le plus connu des deux, permet à une banque d'étendre le financement des stocks à un grand nombre de fabricants de marchandises, de producteurs de produits de base et de négociants de ces marchandises et produits. L'article 177, un peu plus récent, permet de financer ceux qui font l'extraction des hydrocarbures et substances minérales. Les deux articles se sont grandement élargis au cours des révisions de la Loi sur les banques de 1980. L'auteur examine dans ce texte les dispositions des articles 177 et 178 et analyse, l'une après l'autre, la création, l'exécution et les priorités des mesures de garantie spéciales qui sont ainsi accordées aux banques en vertu de ces articles.

Introduction

Sections 177 and 178 of the Bank Act¹ provide Canadian chartered banks with certain special powers to make secured loans to business borrowers.

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¹ As re-enacted by the Banks and Banking Law Revision Act, 1980, S.C. 1980-81-82-83, c. 40. In an attempt to minimize confusion, references in this article to former sections 82 and 88 have been re-numbered as references to new sections 177 and 178, respectively.

These provisions establish forms of security interests that are unique to the chartered banks, since by definition no other type of financial institution may have resort to them. The ready availability of these special security mechanisms on a national basis, in the case of section 178 for close to a century and in the case of section 177 since 1954, has probably assisted the chartered banks in acquiring their position as Canada's dominant commercial lenders.

The special position accorded to security interests under sections 177 and 178 stems in large part from their history. One of the initial objectives of the Bank Act, in the 1870's, was the safeguarding of the liquidity of Canadian banks. Early versions of the Act thus generally discouraged the banks from lending on the security of fixed and non-negotiable assets.² But the framers of the Act also wanted the banks to be able to offer financing to manufacturers and to producers of primary products.³ The problem was that, while early manufacturers and primary producers were often short of capital, the banks were not then empowered to take mortgages on the assets they had to offer. Thus, a potential borrower often had no security to give a bank of a kind that the bank was then allowed to take.⁴

When the first forerunner of section 178 was added to the Bank Act in 1890, the new power of the banks to take a direct pledge of raw and manufactured products was seen not as a benefit to the banks but as a form of assistance to business borrowers.⁵ Even after the prohibition against banks taking mortgages no longer applied, section 178 remained useful because it "often provide[d] the most effective, inexpensive, and convenient way of obtaining security for the eligible classes of borrowers".⁶

² W. Moodie, Accounts Receivable, Section 88 of the Bank Act, and Inventory Financing—A Banker's View, in *Security in Moveable Property*, Meredith Memorial Lectures (1967), p. 49.

³ Sir Edmund Walker said:

[T]he late Mr. Lash and myself framed [section 178] in the early days in this country. . . in order that the manufacturer [etc.]. . . could borrow from the bank without endorsers or anything of that kind, by pledging the material to the bank.

See Canadian Bankers Association, *Bank Act Revision Proceedings* (1933), p. 236.

⁴ E.L. Patterson, *Canadian Banking* (1932), p. 217.

⁵ Sir Frederick Williams-Taylor said that section 178 was conceived "... not in the interests of the banks, but in the interests of a community where the amount of accumulated wealth was naturally small. . ."; see Canadian Bankers Association, *op. cit.*, footnote 3, p. 235.

⁶ J.A. Galbraith, *Canadian Banking* (1970), p. 226. In the same vein, Moodie, *loc. cit.*, footnote 2, at p. 50, wrote:

. . . section [178] now simply constitutes a blue print which enables us to follow a familiar procedure . . . I should also say that its continuance rests on an equally desirable factor, namely, low cost. By means of the procedure established through section [178] a borrower can give security more easily, more quickly and far more cheaply than by any other means.

This concern for the borrower is perhaps why section 178 was broadened during the last decennial revisions to the Bank Act, at a time when other changes seemed to reflect a trend towards curtailing bank powers and privileges.⁷ Under the Act as revised in 1980, section 178 added retailers to the list of eligible borrowers (which were traditionally confined to manufacturers, wholesalers and primary producers), and allowed section 178 security to be given on a much broader range of inventory and other assets.

The predecessor to section 177 was added to the Bank Act in 1954 to help finance the petroleum industry following the major oil discoveries in the West during the late 1940's. It was said at the time that:⁸

. . . the intention of [section 177] was to extend to loans made on oil in the ground similar security to that afforded by section [178] in the case of goods, wares and merchandise and the security here will be analogous to the security taken under section [178].

While originally confined to hydrocarbons and related rights, licences and permits, section 177 was also broadened in 1980 to allow minerals and mineral rights to be taken as security.

This article will examine the special security arrangements that are available to the chartered banks under sections 177 and 178, focussing on the provisions of those sections that relate to the creation, enforcement and priorities of the security. Part I will deal with section 178, the older and generally more familiar form of security, while Part II will discuss section 177.

I. Section 178

A. *Creation of the Security*

(1) *Documentation and Registration*

Security under section 178 is given to a bank by means of an assignment in the form of Schedule F or Schedule G to the Bank Act. Schedule F is used to give security on all property of specified kinds owned by a borrower from time to time, while Schedule G is used to give security on particular items of property owned or to be acquired by a borrower.

The actual assignment by the borrower is not registered, however. Instead, under subsection 178(4) a Notice of Intention is to be registered

⁷ It has been suggested that the proposals in the federal government's 1976 White Paper and the provisions of the revised Act ". . . reflect the perception that the chartered banks dominate the Canadian financial system too strongly". See R.M. MacIntosh, *The 1980 Bank Act Revision: An Overview*, in *New Developments in Commercial Lending*, Meredith Memorial Lectures (1981), p. 6.

⁸ Statement by the Honourable Mr. Abbott, *Proceedings of the Standing Committee of the House of Commons on Banking and Commerce* (1954), p. 1640.

in the form of Schedule H to the Act, setting out the borrower's intention to give section 178 security.⁹ The Notice of Intention must be registered in the appropriate Bank of Canada office not more than three years prior to the execution and delivery of the assignment by which the security is actually given. The appropriate Bank of Canada office will generally be the one located in the province where the borrower has its place, or principal place, of business.

The Notice is to be signed by the borrower, but it does not identify the principal amount that is to be advanced or even the nature of the collateral. In fact, the mere registration of a Notice of Intention does not necessarily mean that section 178 security has been or ever will be given by the borrower. No limit is placed on the number of assignments under section 178 that may be made by the borrower within three years after registration of the Notice of Intention. If a Notice of Intention is not registered, by section 178(4)(a) the rights and powers of the bank in respect of the secured property are void as against creditors of the assignor and as against subsequent purchasers or mortgagees in good faith of the secured property.¹⁰

In the case of secured property that has been assigned by a farmer or forester under section 178(1)(c), (g), (h) or (j), subsection 179(2) also requires the bank to register or file its interest in the appropriate provincial land registry office if the property is or has become affixed to real property (except where the relevant provincial law does not permit the registration or filing of the bank's document). In the case of security under section 178(1)(i) on a fishing vessel registered under the Canada Shipping Act¹¹ or under the Maritime Code,¹² section 179(3) requires the bank to also register its interest under the shipping legislation as if it had taken a mortgage on the vessel in order to preserve its priority over rights in the vessel subsequently registered under that legislation.¹³

⁹ The precise wording of the Schedules need not be followed. With respect to a Notice of Intention, for instance, subparagraph 178(4)(f)(iv) provides that the document may be of "like effect" to Schedule H. In *Royal Bank of Canada v. MacKenzie*, [1932] S.C.R. 524, the bank used Form C instead of Form E (as they then were), but the security was still valid since the documents were to the "like effect".

¹⁰ Earlier versions of the Act did not require that a Notice of Intention be registered. As a result, the security was sometimes characterized as the banks' "secret lien". In the 1923 revision, a requirement was added that the borrower provide a Notice of Intention to give security which was to be registered according to the Act. The details of the registration system for Notices of Intention are set out in regulations made under subsection 178(5): see the Registration of Security Regulations, SOR/82-113.

¹¹ R.S.C. 1970, c. S-9.

¹² Maritime Code Act, S.C. 1977-78, c. 41, sch. III (not yet in force).

¹³ Where a vessel is assigned to a bank at a time when it is not registered under the Canada Shipping Act, *supra*, footnote 11, and the vessel is later registered under that Act, the bank need not register under that Act unless new or additional security is given. The

To release its security, the bank registers a certificate of release in the appropriate Bank of Canada office pursuant to section 178(4)(b). This step permanently cancels the particular Notice of Intention; it cannot be used to "lift" the security temporarily. In *Re Weiss Air Sales Ltd.*,¹⁴ a bank registered a certificate of release in order to facilitate a proposed sale of inventory by the debtor. After the proposed sale fell through, the bank sought to reinstate its security with a new Notice of Intention. No new assignment was made and no further funds were advanced. The court held that the cancellation of the original Notice of Intention by the bank released its section 178 security. Thus, upon a later default the bank could not enforce its security by seizing the debtor's assets because it was then only an unsecured creditor. The court said:¹⁵

While under other systems, steps can be taken to temporarily "lift" liens, charges or encumbrances, or to rearrange priorities, there is no such mechanism in the *Bank Act*.

(2) *Scope of the Security*

(a) *Eligible Borrowers and Property Available as Security*

Section 178 allows banks to "lend money and make advances" to certain specified borrowers on the security of certain specified kinds of property. Paragraphs (a) and (b) of subsection 1 are the most important provisions here. They permit a bank to lend money and make advances:

- (a) to any wholesale or retail purchaser or shipper of, or dealer in, products of agriculture, products of the forest, products of the quarry and mine, products of the sea, lakes and rivers or goods, wares and merchandise, manufactured or otherwise, on the security of such products or goods, wares and merchandise and of goods, wares and merchandise used in or procured for the packing of such products or goods, wares and merchandise,
- (b) to any person engaged in business as a manufacturer, on the security of goods, wares and merchandise manufactured or produced by him or procured for such manufacture or production and of goods, wares and merchandise used in or procured for the packing of goods, wares and merchandise so manufactured or produced.

The restrictions in these provisions help to define the scope of section 178 security.

The first restriction of note is that section 178(1) only permits a bank to "lend money and make advances". Thus a bank may not take security from any person other than the borrower itself, such as from a guarantor of the borrower's debts and liabilities to the bank. There must be a loan or

bank's section 178 claim has priority over subsequent mortgages registered against the vessel: see *Royal Bank of Canada v. Queen Charlotte Fisheries Ltd.* (1981), 13 B.L.R. 306 (B.C.S.C.).

¹⁴ (1982), 134 D.L.R. (3d) 706 (Ont. H.C.).

¹⁵ *Ibid.*, at p. 709.

an advance directly to the person giving security for section 178 security to be available for that loan or advance.

Secondly, the loan or advance can only be made to certain classes of eligible business borrowers. Prior to the revision of the Act in 1980, section 178(1)(a) was limited to "any *wholesale* purchaser or shipper of, or dealer in" the specified kinds of property. Case law developed, by necessity, in which "wholesale dealers" were distinguished from "retail dealers".¹⁶ The extension of the provision in 1980 to "retail" purchasers, shippers and dealers means that this distinction need no longer be drawn. Section 178(1)(a) now includes virtually all commercial dealers in, and shippers and purchasers of, the kinds of property specified. Similarly, section 178(1)(b) allows manufacturers to give security on specified property. Section 2(1) of the Act defines "manufacturer" in broad terms to include:

any person who manufactures or produces by hand, art, process or mechanical means any goods, wares and merchandise . . .

The definition specifically mentions a number of persons who are also to be considered as manufacturers, notably any "refiner and producer of petroleum". Service industries are not, however, included in either provision.

Thirdly, the loan or advance can only be made on the security of certain specified property. Under section 178(1)(a) and (b) the borrower may grant security in various listed types of property, which are further defined in section 2(1). The phrase "goods, wares and merchandise", for example, includes all "articles of commerce" within the scope of both provisions. This phrase was found in section 178(1)(b) before 1980, but is new in section 178(1)(a) and thus adds a further dimension to the kinds of property that can be secured thereunder. Other assignable property includes products of agriculture, of the forest, of the quarry and mine, and of the sea, lakes and rivers, and equipment used for packing any such products or goods, wares and merchandise. Section 2(1) defines the "products of the quarry and mine" to include "minerals" and "hydrocarbons" which in turn are also defined very broadly in section 2(1). However, intangible property (securities, for instance) and real property are not included in either of paragraphs (a) or (b) of section 178(1).

Traditionally, section 178(1)(a) and (b) have enabled banks to take security over raw materials, work-in-progress, wholesale inventories, and equipment used for packing such raw materials and inventories. The addition of the words "goods, wares and merchandise" in section 178(1)(a), together with its extension to "retail purchasers, shippers and dealers", has significantly broadened its scope. The end result is that almost every manufacturer of or commercial dealer in tangible personal property, includ-

¹⁶ See, for instance, the discussion in A.W. Rogers, *Falconbridge on Banking and Bills of Exchange* (7th ed., 1969), p. 232.

ing hydrocarbons and other resource commodities, will now be able to give section 178 security on that property.

Paragraphs (c) to (j) of section 178(1) list a number of other eligible borrowers and the kinds of property on which loans and advances made to these borrowers can be secured. Paragraphs (c) to (h) permit a bank to lend money and make advances to farmers on the security of their crops, agricultural equipment or implements, seed grain or seed potatoes, fertilizer or pesticide, and feed or livestock. Paragraph (i) allows fishermen to assign their fishing vessels, equipment and catch. Paragraph (j) applies to forestry producers and their supplies, equipment and forestry products. Security taken under several of these paragraphs is not effective, however, with respect to equipment or products that, at the time security is taken, are exempt by statute from seizure under writs of execution.

(b) *Promise to Give Security*

Section 178 permits a bank to take security in both presently-owned and after-acquired property. Subsection (2) provides that delivery of a document giving section 178 security to a bank vests in the bank certain rights and powers in respect of the property described in the document:

- (a) of which the person giving security is the owner at the time of the delivery of the document, or
- (b) of which that person becomes the owner at any time thereafter before the release of the security by the bank, whether or not the property is in existence at the time of the delivery [of the document].

Security under paragraphs (a) and (b) can thus attach to property subsequently acquired by the borrower, even if the property does not exist at the time the assignment is made under section 178. This facilitates the use of revolving lines of credit for inventory financing purposes, under which the borrower can draw against or pay down its line of credit depending on its ongoing inventory requirements. Because the section 178 security given to secure such a line of credit also extends to after-acquired property, any property subsequently acquired by the borrower that is of the kind specified in its section 178 assignment, such as its future inventory, will then be subject to that section 178 security automatically.

However, an additional step is required in line of credit financings that are to be secured, at least in part, on after-acquired property. This is because of section 180(1), under which section 178 security is only available to secure an advance if the advance is made at the same time as the section 178 security is given by the borrower, *or* if the borrower gives to the bank at the time of the advance its written promise or agreement to give such security to the bank. Section 180(1) states in part:

A bank shall not acquire or hold . . . any security under section 178, to secure the payment of any . . . loan or advance unless the . . . loan or advance is contracted or made

- (a) at the time of the acquisition thereof by the bank, or
 - (b) on the written promise or agreement that . . . security under section 178 would be given to the bank, in which case the . . . loan or advance may be contracted or made before or at the time of or after such acquisition,
- and such . . . loan or advance may be renewed, or the time for the payment thereof extended, without affecting any security so acquired or held.

A written promise or agreement to give section 178 security is thus required for inventory financings under a revolving line of credit because, by definition, it is intended that advances under the line of credit will be made after the time when the security under section 178 is given to the bank (the assignment under section 178 being given at the time of the first advance under the line of credit).

In the simplest section 178 transaction, a Notice of Intention is registered and the bank then lends a single sum to the borrower against an assignment giving section 178 security. Where a bank grants a revolving line of credit, the first step is the same because the Notice of Intention must be registered before any assignment is made by the borrower. The bank then acquires its security by an assignment from the borrower under section 178 at the time of the first advance under the line of credit (the security including all after-acquired property of the kind specified in the assignment). If a written promise by the borrower to give section 178 security is also given to the bank at the time of the first advance, the bank may then make subsequent advances under the line of credit without a fresh assignment under section 178 being required for each.

It should be noted, however, that the written promise to give security under section 180(1) is not the same as the assignment under section 178, by which the security is actually given. The promise to give security is only a pre-condition to the application of the security to after-acquired property, and does not in itself vest in the bank the rights and powers conferred by section 178(2). An actual assignment must still be made under section 178(1) to accomplish this result.

(3) *Nature of the Security*

Several commentators have attempted to describe the nature of section 178 security by analogy to other security interests. For example, some have described section 178 security in terms of a pledge.¹⁷ This analogy is not really accurate, however. A pledge is a bailment of property, by which a borrower gives possession of its goods to a lender as security for a debt or obligation. A pledge passes possession of the property to the lender but does not pass title (until default, at least). Physical possession of property does *not* pass under a section 178 security; in fact, it is designed to have quite the opposite result. Title to

¹⁷ See, for instance, Patterson, *op. cit.*, footnote 4, p. 217; Galbraith, *op. cit.*, footnote 6, p. 226.

property effectively *does* vest in the bank under section 178, as will be discussed below.

A more appropriate analogy for section 178 security is a chattel mortgage. Like the person assigning section 178 security, the chattel mortgagor retains possession of the property while title to the property vests in the chattel mortgagee (subject to the right of redemption on re-payment). As one commentator has said,¹⁸ a bank acquiring a section 178 security is "virtually in the position of a mortgagee holding the legal title, subject to the borrower's rights of redemption". Reinforcing this analogy are cases such as *Bank of Montreal v. Guaranty Silk Dyeing & Finishing Co.*,¹⁹ where it was suggested that section 178 security is essentially the same as a mortgage.

On the other hand, it is clear that section 178 security is not *identical* to a chattel mortgage. For instance, in *Guimond v. Fidelity-Phenix Fire Insurance Co.*,²⁰ the Supreme Court of Canada held that a clause in an insurance policy which voided the policy in the event that the insured property became "encumbered by a chattel mortgage" did not apply to an assignment of the insured property to a bank under section 178. Similarly, in *Canadian Imperial Bank of Commerce v. Heppner*,²¹ a section 178 security was held not to be a chattel mortgage for the purposes of a provincial statute which provided that a seizure under a chattel mortgage could lawfully be made only by the sheriff.

While these analogies are helpful, section 178 security is a special statutory creation and its true nature really arises from the provisions of the Bank Act itself. In this regard, subsection (2) gives a bank certain specified rights and powers in respect of the property described in an assignment made under section 178. In the case of an assignment under paragraph (a) or (b) of subsection (1), these are "the same rights and powers as if the bank had acquired a warehouse receipt or bill of lading in which such property was described".

Warehouse receipts and bills of lading are documents of title which acknowledge that the goods of one person have been received by another. Section 2(1) of the Act includes extended definitions of these terms, the effect of which is to expand their usual meanings to other documents that might not ordinarily be considered to be warehouse receipts or bills of lading. For instance, clause (e) of the definition of a "warehouse receipt" brings in any receipt given by any person for any hydrocarbons received by him as a bailee, "whether his obligation to restore requires delivery of

¹⁸ Ian F.G. Baxter, *The Law of Banking* (3rd ed., 1981), p. 211.

¹⁹ [1935] 4 D.L.R. 483, [1935] O.R. 493 (Ont. C.A.).

²⁰ (1912), 47 S.C.R. 216.

²¹ (1965), 51 D.L.R. (2d) 254, 52 W.W.R. 295 (Sask. Q.B.).

the same hydrocarbons or may be satisfied by delivery of a like quantity of hydrocarbons of the same or a similar grade or kind”.

Quite apart from the Bank Act, acquisition of a warehouse receipt or bill of lading typically passes title to the goods covered thereby. However, section 186 of the Act amplifies upon the rights and powers that a bank acquires when it takes a warehouse receipt or bill of lading as security. By subsection (2), any warehouse receipt or bill of lading acquired by a bank under that section vests in the bank, from the date of its acquisition, “all the right and title to the warehouse receipt or bill of lading and to the goods, wares and merchandise covered thereby of the previous holder or owner thereof”. As well, by section 179(7) the bank’s interest under a warehouse receipt, bill of lading or section 178 security is not affected as the subject goods, wares and merchandise are converted or incorporated into other goods, wares and merchandise in the process of manufacture or production.

The result, then, is that a bank taking security under section 178 effectively acquires legal title to the borrower’s interest in the present and after-acquired property assigned to it by the borrower. The bank’s interest attaches to the assigned property when the security is given or the property is acquired by the borrower and remains attached until released by the bank, despite changes in the attributes or composition of the assigned property. The borrower retains an equitable right of redemption, of course, but the bank effectively acquires legal title to whatever rights the borrower holds in the assigned property from time to time.

Because of its scope and flexibility, some commentators have suggested that section 178 security is in the nature of a floating charge.²² This can be misleading, however. Because the bank effectively acquires legal title, section 178 security is really in the nature of a fixed charge on the present and after-acquired property of the borrower assigned to the bank. One attribute that section 178 security may be said to share with a floating charge is its application to all property of a specified class held by the borrower from time to time. But while a floating charge may apply to all property of a specified kind held by the borrower from time to time, it does not affix itself specifically upon any particular item of property until it crystallizes upon default by the borrower. Conversely, a section 178 security is a fixed charge on each item of assigned property held from time to time whether or not the loan is in default. This gives a bank significantly greater rights than it would hold under a floating charge debenture on inventory.

At the same time, the flexibility of section 178 security means that the borrower does not require a specific release of the bank’s security in

²² See, for instance, D.R. Johnson, *Accounts Receivable Financing in Canada: Nature of the Charge and Rights of Priority* (1981), 15 U.B.C. L. Rev. 87, at p. 144.

order to deal with each item of assigned property, as would be the case if inventory were secured by a fixed charge contained in a chattel mortgage to the bank. Since the bank becomes effectively the legal owner of the property secured under section 178, the borrower cannot dispose of the assigned property without the consent of the bank. A specific release of the security by the bank could be given each time an item of secured property was disposed of, but this procedure would be unduly cumbersome for both the bank and the borrower. The usual practice is for a bank to grant its borrower a general licence to dispose of the secured property in the ordinary course of business of the borrower. This licence is usually granted in a general agreement between the bank and the borrower, which sets out their relationship with respect to the section 178 security. Because of the nature of the bank's security, if the borrower deals with the secured property otherwise than in accordance with the licence to deal granted by the bank (for instance, a sale out of the ordinary course of business), a purchaser of the property from the borrower may be liable to the bank for conversion of the property even if he is an innocent purchaser who does not know of the bank's security.²³ Proceeds of sale usually will be realized by a borrower who deals with property secured under section 178 in accordance with the licence to so deal granted by the bank. Because the bank has then permitted the dealing, its security on the property itself will not follow the property into the purchaser's hands. However, because of the nature of section 178 security, the interest of the bank will follow automatically into the proceeds generated by a sale of inventory under the licence granted by the bank. This will be the result even in the absence of a formal assignment of book debts to the bank, so long as the proceeds can be traced back to property secured under section 178.²⁴ In that circumstance, the proceeds can be seen as a substitute for the property sold, as would any further property purchased with those proceeds (provided again that the proceeds can be traced into such other property).

Security assigned to a bank under paragraphs (c) to (j) of section 178(1) has the same attributes as those discussed above with respect to paragraphs (a) and (b). In some cases, however (largely confined to crops, agricultural equipment and forestry equipment), the bank also acquires a "first and preferential lien and claim" on the secured property under section 178(2)(d). As a supplement to the rights arising from effectively holding legal title to this kind of property, this "first and preferential lien and claim" appears intended to give the bank priority over those holding security on real property to which such crops, agricultural equipment or forestry equipment might be or become attached, as the rights of the bank are said to "subsist notwithstanding that the property is affixed

²³ *Toronto-Dominion Bank v. Dearborn Motors Ltd.* (1968), 64 W.W.R. 577 (B.C.S.C.).

²⁴ *Flintoft v. Royal Bank of Canada*, [1964] S.C.R. 631, 47 D.L.R. (2d) 141.

to real or immovable property and notwithstanding that the person giving the security is not the owner of that real or immovable property”.

B. Enforcement of the Security

(1) Seizure and Sale of the Secured Property

Two provisions of the Act govern the bank's right of recovery upon a borrower's default under a section 178 security.

Subsection (3) gives the bank the right to seize property assigned under any of paragraphs (c) to (j) of subsection (1) by farmers, fishermen or foresters in any of the events of non-payment, failure to care for the secured property, unauthorized disposition of the secured property, or seizure of the secured property by others. Upon any of such events occurring, the bank has the power to enter on land or premises when necessary, to care for and harvest crops, and to remove the secured property. Section 179(6) imposes a duty on a bank seizing property under section 178(3) to sell the property as soon as is reasonably practical having regard to the nature of the property.

Section 179(4) is the general provision under which a bank may sell property assigned to it under section 178. It applies to all security taken under section 178, including paragraphs (a) and (b) of subsection (1), and empowers the bank, in the event of non-payment, to sell all or any part of the property assigned as security. The proceeds are to be applied to the debt, with interest and expenses; any surplus is to be returned to the person who gave the security. Unless the debtor has agreed otherwise or the property is perishable, the power of sale is to be exercised in accordance with section 179(4)(a) and (b). The sale is to be carried out by public auction, and (except in the case of a sale of livestock) prior notice of the sale must be given to the debtor (thirty days in the case of forest products, ten days in other cases). The sale must be publicly advertised at least two days beforehand (five days in the case of livestock). The sale of the property vests in the purchaser all the right and title in and to the property that the debtor had when security was given under section 178 and that it acquired thereafter.

In connection with any sale pursuant to section 179(4), or pursuant to any agreement between the bank and the person by whom the security was given, section 179(5) imposes on the bank duties to “act honestly and in good faith” and to “deal with the property in a timely and appropriate manner” having regard to the nature of the property and the interests of the person who gave the security. The subsection also imposes a duty to give “reasonable” notice of a sale made under an agreement with the borrower rather than under section 179(4), as in this situation the statutory notice requirement in subsection (4) typically would have been waived by the borrower.

If the bank does not exercise its power of sale in compliance with the Act, by section 189(3) the bank is guilty of an offence and liable on summary conviction to a fine not exceeding \$500. It may also be that a court would overturn a sale not made in accordance with section 179(4) and (5), or at least that a court would award damages against the bank if overturning the sale itself would penalize the third party who bought from the bank. In one recent case, for instance, the court disallowed a significant proportion of a bank's claim for the deficiency owing on a loan secured under section 178.²⁵ In the circumstances, the bank had committed several serious breaches of its obligations under section 179(4) and (5) in the course of realizing upon its security, and so could only recover the portion of the deficiency that would have been outstanding had it acted properly.

Where a third party guarantees to a bank any debt in respect of which a bank has taken security under section 178, and the debt is paid by the guarantor, by section 179(8) the guarantor is subrogated in and to all the powers, rights and authority of the bank under the security that the bank holds in respect of the debt under sections 178 and 179. It appears, therefore, that the guarantor can enforce its security by sale in the same manner as the bank.

(2) *Entitlement to Proceeds*

The Act does not directly define the bank's rights when goods secured under section 178 are sold and give rise to proceeds in the hands of the borrower. Rather, the bank's rights to such proceeds arise by virtue of the nature of section 178 security and the relationship between the bank and its borrower.

As was discussed above, security under section 178 is in the nature of a fixed charge on each item of the secured property that is owned by the borrower from time to time. Because of this fixed charge, a borrower has no power to deal with the secured property except to the extent that it has the bank's express or implied consent to do so. If the borrower disposes of any of the secured property without the consent of the bank, the innocent third party purchaser may be held liable to the bank in conversion if it has re-sold those assets. For instance, in *Toronto-Dominion Bank v. Dearborn Motors Ltd.*,²⁶ the innocent third party purchaser of chattels subject to section 178 security was held liable to the bank even though the borrower/seller had represented to it that the goods were free from encumbrances.

²⁵ *Canadian Imperial Bank of Commerce v. Whitman* (1983), 147 D.L.R. (3d) 110 (N.S.S.C.).

²⁶ *Supra*, footnote 23.

In its general agreement with a borrower regarding section 178 security, a bank will usually give its express consent for the borrower to deal with the secured property in the ordinary course of business. This general permission or licence to deal is essential to permit a borrower to deal with inventory secured under section 178(1)(a) or (b), as it would not be feasible for the borrower to obtain a specific release of the security from the bank each time it wished to sell an item of inventory. When the borrower deals with its inventory by selling in the ordinary course of business, the bank's section 178 security will not follow the inventory into the hands of the third party purchaser because the bank has released that security under its general agreement. However, as is shown by *Flintoft v. Royal Bank of Canada*,²⁷ the bank's security under section 178 follows automatically into the proceeds that the borrower realizes upon the sale of its inventory.

Flintoft involved a dispute between a bank and the debtor's trustee in bankruptcy over the rights to certain uncollected debts owing to the debtor at the date of bankruptcy. The bank had taken both section 178 security and a general assignment of book debts. The book debt assignment was void for improper registration. Nonetheless, the Supreme Court of Canada held that the bank was entitled to those outstanding book debts owing to the debtor for goods sold that had been subject to the bank's section 178 security. Judson J. said:²⁸

... with the consent of the bank, the one who gives the security sells in the ordinary course of business and gives a good title to purchasers from him. But this does not mean that he owns the book debts when he has sold the goods. To me the fallacy in the dissenting reasons is the assumption that there is ownership of the book debts in the bank's customer once the goods have been sold and that the bank can only recover these book debts if it is the assignee of them.

The bank was thus entitled to the proceeds that stood in the form of book debts owing to the debtor, even though it held no separate assignment of those book debts. Its section 178 security was of such a nature that it followed automatically into those proceeds when they arose as a result of a sale with the bank's consent.

In *Flintoft* there was an express agreement in writing between the bank and its customer that proceeds were to be held in trust by the customer for the bank. However, even without such an express provision it would appear that an "oral understanding" would suffice, and that the court may well presume such an understanding. Judson J. said that "[a]ny other understanding would be inconceivable in commercial dealings".²⁹ He concluded:³⁰

²⁷ *Supra*, footnote 24.

²⁸ *Ibid.*, at pp. 634 (S.C.R.), 144 (D.L.R.).

²⁹ *Ibid.*, at pp. 635 (S.C.R.), 145 (D.L.R.).

³⁰ *Ibid.*, at pp. 636 (S.C.R.), 145 (D.L.R.).

. . . I can find in the report no mention of any agreement in writing, but even in its absence the principle is plainly to be spelled out that if you sell my goods with my consent, it is on terms that you bring me the money in place of the goods.

The book debts were thus "never the property of the customer" and so could not be affected by the assignment in bankruptcy. They were the property of the bank, which had been the owner of the goods sold. The nature of section 178 security, effectively vesting in the bank the borrower's title to the secured property, thus carries the bank's rights into any proceeds realized when the secured property is sold with the bank's consent.

C. Priorities

(1) Under Sections 178 and 179

Section 179(1) sets out the basic provisions governing the priority of the bank's claim under section 178. It provides that the bank's rights in the secured property have priority "over all rights subsequently acquired in, on or in respect of such property", and also over "the claim of any unpaid vendor" except where the unpaid vendor has a lien on the property and the bank has knowledge of that lien at the time it takes its section 178 security.³¹

It is not clear what constitutes a "vendor's lien" in this context. The term is not defined in the Act. Usually a lien is a claim or charge on property for payment of some debt, duty or obligation. An ordinary unpaid vendor has no such lien on goods sold and delivered by him, since a lien is a form of security interest that, in this context, would only arise if specifically contracted for. On the other hand, the decision in *Rogerson Lumber Co. Ltd. v. Four Seasons Chalet Ltd.*³² appears to establish that a conditional vendor is not an "unpaid vendor" for the purpose of section 179(1), even though it has contracted to reserve title as security until paid in full. The "vendor's lien" provisions in section 179(1) thus seem to apply only in some middle ground, between the ordinary unpaid vendor who has done nothing to reserve a lien and the true conditional vendor who has taken the most effective kind of vendor's security possible. An unpaid vendor who has taken back a chattel mortgage may fall into this middle ground, as may a vendor who is in a position to claim a seller's lien under a provincial Sale of Goods Act.

³¹ An improver's lien represents a special case. In *Bank of Montreal v. Guaranty Silk Dyeing & Finishing Co.*, *supra*, footnote 19, the debtor sent fabric secured by a section 178 assignment to processors for dyeing. The bank consented to this undertaking. The dyers were held to be entitled to hold the goods until their lien was satisfied. An improver's lien extends, however, only to the value added by it to the goods.

³² (1980), 29 O.R. (2d) 193 (Ont. C.A.).

Apart from these difficulties, section 179(1) clearly establishes that a bank's section 178 security takes priority over competing claims that arise or are created at a time later than the assignment to the bank. This clear priority of a section 178 security, coupled with the effective legal title that such security gives a bank, puts the bank in a strong position as against other creditors under the terms of the Act.³³ Other considerations come into play, however, when provincial security interests are in competition with a section 178 security.

(2) Section 178 and Provincial Security Interests

Canada has a federal banking system providing for its own special type of security interests. There is no requirement that a bank comply with provincial law in order to create a valid and enforceable section 178 security. This does not necessarily mean, however, that federal law can override all provincial legislation on priorities, or that a bank can safely ignore all such provincial legislation.

Section 178 can come into conflict with provincial legislation because a bank's security may be entitled to priority over other secured creditors without the bank having complied with provincial legislation. Because the bank need not comply with the provincial regime, the priority rules of that regime are not applicable to the bank's section 178 security. The courts must then sort out, in particular cases, not only the priorities among the competing securities but also the relationship between the two separate regimes under which those securities have been created.

It is beyond the scope of this article to consider the specific techniques by which the courts may try to resolve conflicts between section 178 and provincial security interests, as these are discussed exhaustively elsewhere in this issue.³⁴ Two points should be made here, however.

First, because of its status as a federal creation, section 178 will usually be strictly construed where it conflicts with provincial law. For example, in *Attorney-General of Canada v. Mandigo*,³⁵ it was held that a federal statute such as the Act may successfully establish specific exceptions to provincial law, but that the intent to vary the principles recognized by the provincial law must be clearly stated. Hyde J. said:³⁶

³³ One exception that arises under the Bank Act itself is found in section 178(6), by which the claims of certain employees and agricultural suppliers have a limited priority over the bank's section 178 security in the event of the bankruptcy of the borrower. However, section 178(6) also provides that the bank becomes subrogated to any such claims that it must satisfy in realizing upon its security.

³⁴ See R.C.C. Cuming and Roderick J. Wood, *Compatibility of Federal and Provincial Personal Property Security Law*, *infra.*, p. 267.

³⁵ (1964), 46 D.L.R. (2d) 563 (Que. C.A.).

³⁶ *Ibid.*, at p. 567.

. . . the Bank's rights to what is something in the nature of a chattel mortgage on moveable property, as given by s. [178] of the *Bank Act*, are exceptional to the civil law of this Province and as such should be interpreted restrictively . . .

However, if the Act is still in conflict with a valid provincial law even after being strictly interpreted, it will be necessary for the courts to resort to some other set of principles, such as theories of federal paramountcy, in order to resolve the conflict.

Second, the exact resolution of any conflict between section 178 and a provincial security regime may well depend upon whether the provincial regime in question is of the more traditional "registration" type, or of the more modern type represented by the Personal Property Security Acts now in force in several provinces. The latter have adopted quite different principles for determining priorities internally, and these do not always mesh very well with the principles used in sections 178 and 179 (which are, in fact, similar to the principles used in the remaining provincial "registration" statutes). In the end, some legislative action may be required to provide a more coherent system for resolving conflicts between section 178 security and provincial Personal Property Security Act regimes.³⁷

(c) *Landlords*

A landlord has a common law right of distress, frequently limited by statute to non-residential tenancies. Distress is the right to seize and hold goods found on the rented premises for unpaid rent in arrears. In Ontario, section 53 of the Landlord and Tenant Act³⁸ expands the common law right by giving the landlord a power to sell the goods seized. Section 31(2) of the same statute restricts the landlord's ability to seize the goods of a third party, so that the right of distress does not extend to "the goods and chattels of any person except the tenant or person who is liable for the rent. . .". But section 31(2) further states that this restriction does not apply to the goods and chattels of third parties whose title is derived by "assignment from the tenant. . . by way of mortgage or otherwise. . .". This subsection confers priority on a landlord over chattel mortgagees and holders of floating charges.³⁹

The landlord's right to distrain has priority over a section 178 security in respect of arrears of rent arising before the section 178 assignment was taken by the bank. In *Re Newmarket Lumber Co. Ltd.; International Wood Products Ltd. v. The Royal Bank of Canada*,⁴⁰ the arrears of rent, and therefore the landlord's right to distrain, arose before the section 178 security was taken. The right to distrain thus was not made subject to the section 178 security by section 179(1). Correspondingly, a right of dis-

³⁷ See Cumming and Wood, *loc. cit.*, footnote 34.

³⁸ R.S.O. 1980, c. 232.

³⁹ E.K. Williams and F.W. Rhodes, *Williams & Rhodes Canadian Law of Landlord and Tenant* (5th ed., 1983), para. 8:24:2.

truss arising after a section 178 assignment is made will be subordinate to the bank's claim.

In some instances, however, it is not clear for these purposes when section 178 security is "taken" in the case of after-acquired property. In *Re Fermo's Creations Inc.*,⁴¹ a series of assignments to the bank under section 178 included after-acquired property. The landlord's right of distress was held to arise subsequent to the taking of the section 178 security, because the first assignment in the series was given before the lease was signed and thus before any rent could fall into arrears. All property acquired by the borrower after the rent fell into arrears was thus covered by the section 178 assignment given to the bank before the rent fell due. A bank taking an assignment under section 178 will thus be subject to the landlord's right of distress only to the extent of any rent in arrears before the assignment is given, even in respect of after-acquired property that the borrower acquires after the rent has fallen into arrears.

(4) *Section 178 and Government Claims*

A bank's section 178 security will occasionally come into conflict with government claims (both federal and provincial) for taxes and other statutory amounts.

In *City of Brantford v. Imperial Bank of Canada*,⁴² the Ontario Court of Appeal held that property assigned to a bank under section 178 was not immune from seizure under provincial taxing legislation. The court concluded that the power of a province to tax carried with it the incidental power to establish priorities as between itself and creditors of the taxpayer. Accordingly, a provincial tax statute may validly stipulate that the provincial Crown's claim for its unpaid taxes ranks ahead of the bank's section 178 interest, though such a stipulation must be clearly expressed.

The federal Crown's claim in respect of its taxes will also attach only to the equity of the taxpayer in its assets, except where express provisions require some other result. In *Attorney-General for Canada v. Gordon*,⁴³ The Special War Revenue Act⁴⁴ provided:

Notwithstanding the provisions of *The Bank Act* . . . the liability to the Crown of any person, firm or corporation, for payment of the excise taxes . . . shall constitute a first charge on the assets of such person, firm or corporation . . .

The borrower was indebted to the federal Crown for excise tax, and it was accepted by the court that this section gave the claim of the federal Crown priority over the bank's section 178 interest.

⁴⁰ [1951] O.R. 642 (Ont. Wkly. Ct.).

⁴¹ (1969), 10 D.L.R. (3d) 560 (Que. C.A.).

⁴² (1930), 65 O.L.R. 625 (Ont. C.A.).

⁴³ [1925] 1 D.L.R. 654, 56 O.L.R. 48 (Ont. S.C.).

⁴⁴ S.C. 1915, c. 8 (5 Geo. V), as amended S.C. 1922, c. 47 (12 - 13 Geo. V), s. 17.

A claim under section 225 of the Income Tax Act (Canada),⁴⁵ which authorizes the seizure of goods and chattels of the taxpayer upon failure to pay income taxes due, will generally not take priority over an earlier-created section 178 security. If the bank holds the taxpayer's goods and chattels under its section 178 security, the federal Crown's claim under this provision will only extend to the taxpayer's interest in the goods and chattels. The Crown would have to return to the bank any goods or chattels seized that were subject to the section 178 security.⁴⁶

The language in which a government claims unpaid taxes or other statutory amounts may thus be important. In *Royal Bank of Canada v. Workmen's Compensation Board of Nova Scotia*,⁴⁷ the Supreme Court of Canada had to consider the effect of a provision giving a provincial government a first lien for worker's compensation assessments upon all the property "used in or in connection with or produced in or by the industry, with respect to which the employer is assessed, though not owned by the employer. . .". The court held that, although the bank had acquired ownership in the goods of the employer-borrower by its section 178 security, its ownership of the goods did not deprive the province of its right to impose the lien on property merely "used by" the employer. In contrast, where the provincial claim was limited to the "property of" the employer, it was held that section 178 security placed the goods outside the employer's capacity to transfer such goods to creditors, and thus outside the preference granted by statute to the provincial Worker's Compensation Board.⁴⁸

II. Section 177

Section 177 security is quite similar to section 178 security in many respects. Section 178 has always been seen as a relatively simple and straightforward technique for banks to acquire effective security. Section 177 is even more simple and straightforward than section 178, perhaps because of its more recent introduction, and it seems to have avoided some of the complicating factors that have become engrafted on to section 178 security over the years. This may be one reason why there has been virtually no reported case law on section 177. The absence in the section of some of the potentially contentious issues in section 178 may simply mean that there has been very little for banks and borrowers to litigate

⁴⁵ S.C. 1970-71-72, c. 63.

⁴⁶ *384238 Ontario Limited v. The Queen* (1981), 81 D.T.C. 5215 (F.C.T.D.).

⁴⁷ [1936] S.C.R. 560, [1936] 4 D.L.R. 9.

⁴⁸ *La Commission des Accidents du Travail de Québec v. Les Industries de Tourville Ltée*, [1951] Que. P.R. 394 (Que. S.C.). See also *Armstrong v. Coopers & Lybrand Ltd.* (1986), 53 O.R. (2d) 468 (Ont. H.C.), in which the language used in a provincial statute allowed claims for vacation pay to prevail over a section 178 security, whereas claims for severance pay and termination pay were subject to the section 178 security.

about. Another reason may be the kind of property to which section 177 security applies. The mineral and hydrocarbon rights that can be secured under section 177 are largely within provincial real property security systems, rather than the more intricate provincial personal property security systems (though the security itself can be created and enforced under section 177 without regard to the historical encrustations on the law of real property mortgages). Finally, it may simply be that the relative health and success of the Canadian petroleum industry since the introduction of section 177 has resulted in comparatively few situations in which a bank holding section 177 security has had to realize upon it in contentious proceedings.

This is not to say, of course, that section 177 is without its own uncertainties. It does mean, however, that there is virtually no guidance to be obtained from the case law in attempting to resolve these uncertainties. Where sections 177 and 178 are parallel, a court may well apply the wealth of case law under section 178 to a dispute on similar language in section 177. But in the absence of actual case law on section 177, and in the absence of direct parallels to section 178, it is the words of section 177 that must be examined in determining the nature, scope and effect of the security created thereunder.

A. Creation of the Security

(1) Documentation and Registration

Section 177(2) provides that security under section 177 is to be given by signature and delivery to the bank of an assignment in the form set out in Schedule I to the Act, or in a form to the like effect. Like Schedule F, as used to give general section 178 security, Schedule I provides that the borrower assigns all property of the kind described in the Schedule to the bank as continuing security for the payment of all loans and advances made or to be made to the borrower by the bank.

Unlike section 178, section 177 does not require the registration of a Notice of Intention in an office of the Bank of Canada. Registration pursuant to section 177 is not a self-contained federal scheme, but rather requires registration in provincial offices. As will be discussed further below, section 177(7) gives a bank's section 177 security priority over subsequent rights and interests. However, section 177(8) states that the bank's rights and powers in respect of the property secured under section 177 do not have priority over any other interest or right in that property unless the bank has made an appropriate registration of its section 177 security prior to the registration of such other interest or right.

The bank's registration must be made in the proper provincial land registry or land titles office, or other provincial office in which the relevant rights, licences or permits are recorded. The registration requirement

does not apply, however, if the particular province does not permit such registration (presumably on the theory that federal legislation cannot require a province to establish or maintain a registration system solely or principally for federal security interests like those under section 177). In the most important mineral-producing provinces, however, the provincial statutes do generally provide for the registration of section 177 security on property within the province.⁴⁹

(2) Scope of the Security

Section 177(1) provides that a bank may lend money and make advances on the security of:

- (a) hydrocarbons or minerals in, under or on the ground, in place or in storage,
- (b) the rights, licences or permits of any person to obtain and remove any such hydrocarbons or minerals and to enter on, occupy and use lands from or on which any of such hydrocarbons or minerals are or may be extracted, mined or produced,
- (c) the estate or interest of any person in or to any such hydrocarbons or minerals, rights, licences, permits and lands whether the estate or interest is entire or partial, and
- (d) the equipment and casing used or to be used in extracting, mining or producing or seeking to extract, mine or produce, and storing, any such, hydrocarbons or minerals.

The security can also be taken on "any rights or interests in or to" any of the kinds of property listed.

Like section 178, section 177(1) requires that a bank "lend money" or "make advances" for the security to be available. Unlike section 178, however, section 177(1) states expressly that section 177 security can be taken either from the borrower or from "a guarantor of the liability of the borrower", or indeed "from any other person". Section 177 thus provides the bank and its borrower with greater flexibility to make appropriate security arrangements for advances where the need for funds does not necessarily match the assets available as security. This may arise, for instance, within a corporate group where one corporation (an exploration subsidiary, for example) requires funds but the group's properties available as security under section 177 are largely held by another corporation within the group.

"Minerals" and "hydrocarbons" are defined very broadly in section 2(1) of the Act. The terms would include virtually every kind of mineral and hydrocarbon presently produced in Canada. As was discussed above, section 178 security can also be taken on "minerals" and "hydrocarbons" since they are defined as being "products of the quarry

⁴⁹ See, for instance, sections 139 to 142 of the Mines and Minerals Act, R.S.A. 1980, c. M-15, and the Crown Land Registration Regulation, Alta. Regs. 420/81 and 385/82, made thereunder.

and mine” for the purposes of section 178(1). Section 177 is primarily concerned with hydrocarbons and minerals *before* production, when they still form part of real property (although the security is also available for hydrocarbons and minerals “in storage” and not just “in place”). In contrast, section 178 is primarily concerned with hydrocarbons and minerals *after* production, as commodities in the flow of commerce.

Section 177(2) parallels section 178(2) in providing that property may be secured:

- (a) of which the person giving the security is the owner at the time of the delivery of the instrument, or
- (b) of which that person becomes the owner at any time thereafter before the release of the security by the bank, whether or not the property is in existence at the time of delivery [of the instrument].

Like section 178 security, therefore, security under section 177 can extend to after-acquired property as well as to property in existence and owned by the borrower at the time the security is given. All such property is expressly defined by section 177(2) to be “property covered by the security” for the purposes of the Act.

(3) *Nature of the Security*

Section 177 does not contain a provision similar to that found in section 178(2), by virtue of which a bank taking section 178 security becomes effectively the legal owner of the secured property. However, the overall effect of section 177 is still to give the bank a fixed charge on the property secured, whether or not that fixed charge can conceptually be equated with ownership. As with section 178 security, the real nature of section 177 security emerges from the specific provisions of the Act that give it effect, rather than from any conceptual analogies to other forms of security interests.

Section 177 security is in the nature of a fixed charge on real property, or at least on a component part of real property (hydrocarbons and minerals in place) and on the rights, licences and permits that allow the component part to be separated from that real property. Such a right, licence or permit usually constitutes a *profit à prendre*, which is a type of interest in hydrocarbons or minerals that gives the holder thereof the right (usually the exclusive right) to recover, capture and take away the hydrocarbons or minerals in, on or under specified lands, but does not usually confer any property right on the holder of the *profit à prendre* in respect of the hydrocarbons or minerals in place before they are recovered or captured. Conceptually, the owner of the lands (often a provincial government) remains the owner of the hydrocarbons and minerals until the person to whom the *profit à prendre* has been granted recovers or captures them. At that point, the owner of the land usually reserves a share out of the production recovered or captured as its royalty, so that the

royalty share remains its property and thus never becomes the property of the holder of the *profit à prendre*.

Because section 177(1) has separated its references to hydrocarbons and minerals from its references to rights, licences and permits (paragraphs (a) and (b), respectively), it seems that the owner of the land (at least where the owner is a private party and not a provincial government), and the holder of a *profit à prendre* from that owner, may each give security under section 177 upon their respective interests in the hydrocarbons or minerals in question. The owner of the land could give section 177 security on the hydrocarbons and minerals in place under paragraph (a), with its loan or advance being repaid out of its royalty share of production. Correspondingly, the holder of the *profit à prendre* could give section 177 security on this right, licence or permit under paragraph (b), with its loan or advance being repaid out of the production remaining after the owner's royalty share has been satisfied.

Fractional and fragmented interests are common in the resource sector, particularly in the petroleum industry. Section 177(1)(c) has taken this factor into account by allowing security to be given on any person's "estate or interest", whether "entire or partial", in hydrocarbons and minerals or in rights, licences, permits or lands. Any one interest holder can thus give section 177 security without, it seems, any difficulties arising because it does not hold the entire interest in a particular property. Section 177(10) seems intended, at least in part, to aid in this result. It allows a bank holding any security on hydrocarbons or minerals to take in lieu of that security, to the extent of the quantity originally secured, security "covering or entitling it to the delivery of the same hydrocarbons or minerals or hydrocarbons or minerals of the same or a similar grade or kind". This would seem to allow for substitute collateral to be taken if the original property secured is not held solely by the particular borrower.

Section 177(1)(d) also permits security to be given on the equipment and casing used in producing or storing hydrocarbons and minerals. Where security is given on such property as well as on the hydrocarbons and minerals or the rights to produce them, virtually the entire production operation would be made subject to the bank's fixed charge under section 177.

B. *Enforcement of the Security*

(1) *Seizure and Sale of the Secured Property*

In addition to whatever other rights or powers it may have (for instance, under a loan agreement with its borrower), by section 177(3) a bank has the right to seize and sell property secured under section 177 in the event of non-payment of the loan or advance, or in the event of "failure to care for, maintain, protect or preserve" the secured property.

This power would permit the bank to seize and sell any hydrocarbons or minerals, or any rights, licences or permits, secured under section 177(1).

In addition, section 177(3) provides that the bank may "care for, maintain, use, [and] operate" the secured property on default by the borrower. These additional powers would allow a bank to go into possession of the secured property and then, rather than selling off the secured property itself (which may not be a feasible step in some circumstances), to operate that property and produce minerals or hydrocarbons from it. The bank could then dispose of the borrower's share of production until its loan was satisfied. Where a bank exercises its rights under subsection (3), subsection (4) requires it to provide "to the person entitled thereto" any surplus proceeds remaining after payment of all the bank's loans and advances "together with interest and expenses".

By section 177(6), a sale of the secured property pursuant to subsection (3) is to be made by public auction unless the person who gave the security agrees otherwise. The sale may take place only after ten days' notice to the person giving security and after two days' notice by newspaper advertisement. There is no provision in section 177 equivalent to section 179(5), which requires a bank to give "reasonable notice" of a sale under an agreement with its borrower relating to section 178 security. As with a failure by a bank to adhere to the sale requirements in respect of section 178 security, failure to follow the prescribed procedures under section 177(6) could lead to the sale being overturned by a court, or at least to the bank being held liable in damages if it did not obtain a reasonable price. By section 177(5), the effect of a sale under section 177(3) is to vest in the purchaser all the right and title in and to the secured property that the person giving the security had when the security was given and that it acquired thereafter.

As is the case with respect to section 178 security, section 179(8) also permits a guarantor of loans secured under section 177 who has paid or satisfied those loans to be subrogated to the powers and rights of the bank in respect of the property secured under section 177. This would give a guarantor who became so subrogated the same powers of realization as the bank would have under section 177(3), including the power to go into possession and produce until the debt is satisfied.

(2) Entitlement to Proceeds

Section 178 deals with the financing of inventories and other moveables, so that the treatment of proceeds of sale is of direct importance. In the case of section 177, the secured property itself (principally hydrocarbons and minerals in place and the rights, licences or permits to produce them) are much less likely to be sold as such by the borrower in the ordinary course of business. The more important question under section 177 with respect to proceeds arises where the person giving the security

sells the *production* from the secured property, rather than the secured property itself.

In such a situation, the bank may be able to assert a claim to the proceeds of sale of the production under the same rationale as that suggested for section 178 security by *Flintoft v. Royal Bank of Canada*.⁵⁰ The potential problem here is that the *Flintoft* rationale depends upon the notion, derived from section 178(2), that the bank is the legal owner of property secured under section 178 and is thus automatically entitled to any proceeds arising from that property.⁵¹ As was noted above, this "ownership" notion is absent from section 177, and so the *Flintoft* rationale may not necessarily apply to proceeds realized from the sale of production from property secured under section 177.

As was also noted above, section 178 security can be taken by a bank on minerals and hydrocarbons after production as they are defined in section 2(1) of the Act to be "products of the quarry and mine". Accordingly, a bank could take a section 178 security from a borrower at the same time as it takes its section 177 security, and thereby gain for itself a much-enhanced claim to the proceeds from the sale of production. In fact, section 177(9) may have contemplated just such a step by providing that a bank may take "any further security it sees fit" on the same property when making a loan or advance on the security provided under section 177. Any provincial security devices taken by the bank (an assignment of book debts, for example) would also be specifically authorized by this provision.

C. Priorities

The priorities given to a section 177 security by subsection (7) are quite similar to those provided for section 178 security under section 179(1). Subject to the registration requirement in section 177(8), the bank's rights in respect of property secured under section 177 "have priority over all rights subsequently acquired in, on or in respect of" the secured property, and over the claim of any mechanics' lien holder or of any unpaid vendor of equipment or casing. As in section 179(1), the claim of an unpaid vendor with a lien on equipment or casing has priority if the bank took its security with knowledge of the lien.

⁵⁰ *Supra*, footnote 24.

⁵¹ See discussion *supra*, footnote 27 *et seq.*