

COMPATIBILITY OF FEDERAL AND PROVINCIAL PERSONAL PROPERTY SECURITY LAW

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The enactment of Personal Property Security Acts in several Canadian jurisdictions in recent years has forced a complete re-examination of the relationship between federal and provincial personal property security law. Changes in banking practices induced by new attitudes toward the use of provincial personal property security law in bank financing have given rise to important questions, the answers to which are not always to be found in established principles.

In this article, the authors examine the legal implications associated with these developments. They seek to dispel some of the misconception which has crept into legal thinking in this area of the law. In addition, they describe a set of approaches to the relationship between sections 178-180 of the Banks and Banking Law Amendment Act and provincial Personal Property Security Acts which, if adopted, would provide a legally sound, if uneasy accommodation between the two systems, based on a recognition of the essential features of each.

L'adoption ces dernières années, dans plusieurs juridictions canadiennes, de lois de garantie portant sur les biens personnels a mené à un examen approfondi de tous les rapports qui existent entre le droit fédéral et les droits provinciaux dans le domaine de la garantie portant sur les biens personnels. Les changements de la pratique bancaire causés par la nouvelle façon de considérer l'usage qu'on peut faire du droit provincial de garantie portant sur les biens personnels en matière de financement par les banques ont soulevé d'importantes questions auxquelles les principes établis ne donnent pas toujours de réponse.

Les auteurs examinent dans cet article les implications en droit de ce développement et cherchent à rectifier quelques idées fausses qui se sont infiltrées dans la pensée juridique dans ce domaine. Ils décrivent de plus un certain nombre de principes ayant pour but d'aborder les rapports entre les articles 178, 179 et 180 de la Loi de 1980 remaniant la législation bancaire d'une part et les lois provinciales de garantie portant sur les biens personnels d'autre part, principes qui, s'ils étaient adoptés, permettraient d'accorder les deux systèmes sur une base solide en droit, sinon facile, en gardant les traits essentiels de chacun.

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Introduction

The system of secured wholesale financing created by the Bank Act has been an important feature of Canadian commercial law for many years.¹ However, it was never intended to be the exclusive means by which secured financing was to be carried on; it developed alongside provincial law governing secured transactions. For the most part, the federal and provincial systems have co-existed in harmony. Until recently, both have been premised primarily upon the transfer of a property interest in goods from the borrower to the secured party, with priority disputes governed primarily by the application of common law and equitable property law principles.

Three relatively recent events are threatening to put an end to more than a century of federal-provincial accommodation in the area of secured financing. The first occurred in 1967 when banks were freed from the prohibition against taking provincial security devices to secure loans.² It is now common practice for banks to take security interests under the Bank Act and under provincial law. Recently some banks have adopted the practice of registering in the personal property registry of the jurisdiction where a loan is made a financing statement relating to a section 178 security interest taken to secure the loan. Other banks have adopted the practice of taking both federal and provincial security interests in the same asset to secure the same obligation. It is important to determine what effect, if any, these practices have on the priority position of banks employing them.

The second and perhaps the most significant recent event in the evolution of Canadian personal property security law has been the enactment of new personal property security legislation in Ontario, Manitoba,

¹ The literature on the Bank Act security system includes: I.F.G. Baxter, *The Law of Banking* (3rd ed., 1981), c. 13; A.W. Rogers, *Falconbridge on Banking and Bills of Exchange* (7th ed., 1969); R.H. McLaren, *Secured Transactions in Personal Property in Canada* (1979); B. Crawford, *Selected Problems with Security, Borrowing from Banks*, (C.B.A. 1984 Annual Institute on Continuing Legal Education); J. Heal, *Life for Banks Under the Personal Property Security Act Regime*, *Meredith Memorial Lectures: New Developments in Commercial Lending* (1981), p. 222; R.A. Macdonald, *Security Under Section 178 of the Bank Act: A Civil Law Analysis* (1983), 43 R. du B. 1007; R.A. Macdonald and R.L. Simmonds, *The Financing of Moveables: Law Reform in Quebec and Ontario*, *Meredith Memorial Lectures: New Developments in Commercial Lending* (1981), p. 246; J. Ziegel and R.C.C. Cuming, *The Modernization of Canadian Personal Property Security Law* (1981), 31 U. of T.L.J. 249, at pp. 254-256.

² The 1967 Bank Act, S.C. 1966-67, c. 87, s. 75(1)(c) empowered the banks to lend money and make advances on the security of personal property. The previous Bank Act, S.C. 1953-54, c. 48, s. 75(2)(d) prohibited a bank from lending money or making advances upon the security of goods, wares and merchandise except by way of a Bank Act security. This prohibition dated back to 1841.

Saskatchewan and the Yukon.³ The Personal Property Security Acts of these jurisdictions are designed to regulate all commercially significant security interests in personal property arising under provincial law. Priorities are no longer determined by application of common law and equitable principles of property law, but are controlled by internal sets of priority rules contained in the Acts. As a result, it is now more difficult to resolve priorities in a competition between a Bank Act security interest and a provincial security interest.

Finally, in 1980 the scope of the federal system was expanded to the point where it is available to virtually any type of borrower on the security of a wide range of tangible personal property.⁴ This expanded scope, if fully exploited by the banks, will likely result in an increase in the number of occasions in which Bank Act security interests come into competition with provincial security interests.

In this article the authors examine some of the more significant problems that are likely to arise when rights under the federal system come into competition with rights asserted under provincial systems of personal property security law. Solutions are offered which, although not always in accord with conventional thinking in this area, are in the authors' opinion sound and for the most part workable. This is not to say that, if adopted, the solutions proposed would produce commercial efficiency, or would satisfy all parties affected. To achieve this a legislative solution is required, preferably worked out through federal-provincial co-operation.⁵

II. *The Bank Act as the Primary Source of Law*

The primary source of law governing competition between a Bank Act security interest and a provincial security interest is the Bank Act itself.⁶ If the Bank Act states or implies a priority rule, then that provision governs notwithstanding that it may conflict with a rule of provincial law. This principle is based on the primacy of federal legislative power respecting matters which under the Constitution Act, 1867 are allocated to Parliament. The Bank Act contains provisions governing the priority of a

³ R.S.O. 1980, c. 375 (hereafter in footnotes O.P.P.S.A.); S.M. 1973, c. 5 (continuing consolidation c. P-35); S.S. 1979-80, c. P-6.1 (hereafter in footnotes S.P.P.S.A.); O.Y.T. 1980 (2d), c. 20, amended S.Y.T. 1982, c. 30. It is expected that other jurisdictions will adopt similar legislation in the near future.

⁴ Banks and Banking Law Revision Act, S.C. 1980-81-82-83, c. 40, s. 178(1)(a) (hereafter in footnotes the Bank Act).

⁵ There is recent precedent for such co-operation. See: Report of the Federal/Provincial Working Group on Central Registry for Security Interests in Aircraft, Jan. 20, 1984.

⁶ Mignault J. in *Landry Pulpwood Company, Ltd. v. La Banque Canadienne Nationale*, [1927] S.C.R. 605, at p. 615 stated: "... we must look solely to the *Bank Act* to determine the effect of a lien acquired by a bank by virtue of section 88 [now section 178]".

section 178 security interest; it also contains provisions governing the rights and duties of a bank when realizing on its security interest. Provincial legislation that limits or restricts the rights of secured creditors does not apply to a bank when proceeding under its section 178 security interest.⁷ A section 178 security interest does not have to be registered in a Personal Property Security Act registry, nor is the priority position of a section 178 security interest governed by the internal rules of a Personal Property Security Act which regulate priorities among security interests.⁸ Although provincial legislation cannot adversely affect the operation of a bank's section 178 security interest, banks have been able to take advantage of provincial legislation which invalidates unregistered provincial security interests. This type of legislation was common before the enactment of Personal Property Security Acts, and remains in jurisdictions that have not yet reformed their personal property security law. For example, a bank can rely upon provincial conditional sales legislation that invalidates a prior unregistered conditional sales agreement.⁹ However, Personal Property Security Acts do not have the same effect. They are self-contained codes and, unlike the older registration statutes, provisions that subordinate one security interest to another apply only to those security interests that are within the scope of the Act.¹⁰

There are a number of provisions in the Bank Act that directly address the priority position of a bank's section 178 security interest. Some do not state true priority rules, but provide prerequisites to the existence of a section 178 security interest. Section 178(1) permits a bank to make loans only to specified categories of borrowers on the security of specified types of collateral. Section 180 provides that a security interest

⁷ *Johnson v. Bank of Nova Scotia* (1985), 41 Sask. R. 292 (Sask. Q.B.), provisions of The Exemptions Act, R.S.S. 1978, c. E-14, are not applicable; *Bank of Montreal v. Hall* (1985), 46 Sask. R. 182 (Sask. Q.B.), provisions of The Limitation of Civil Rights Act, R.S.S. 1978, c. L-16, are not applicable. It should, however, be noted that Matheson J. in *Bank of Montreal v. Hall* indicated that the constitutional validity of s. 178(3), insofar as it insulates the bank from provincial consumer protection laws, may be brought into question in the future.

⁸ *Rogerson Lumber Co. Ltd. v. Four Seasons Chalet Ltd.* (1980), 113 D.L.R. (3d) 671 (Ont. C.A.).

⁹ See, e.g., *Royal Bank of Canada v. Hodges*, [1929] 3 W.W.R. 605 (B.C.C.A.).

¹⁰ *Rogerson Lumber Co. Ltd. v. Four Seasons Chalet Ltd.*, *supra*, footnote 8, per Arnup J.A. at p. 677. See also J.S. Ziegel, *The Quickening Pace of Jurisprudence under the Ontario Personal Property Security Act* (1979), 4 C.B.L.J. 54, at pp. 63-64, who stated:

It might be thought that since s. 88(4) [now s. 178(4)] of the Bank Act subordinates an unperfected s. 88 security interest to the rights of creditors of the debtor and subsequent purchasers and mortgagees of the property covered by the security, the converse should also hold true where a bank obtains an assignment subject to a prior unperfected security interest governed by provincial law. However, this involves reading into the Act an important provision not presently found in it.

cannot secure any advance made prior to the acquisition of the security interest or a written promise to give it. If these preconditions are not met, the bank, although attempting to take section 178 security interest, will have failed to do so. The security agreement will therefore be governed by provincial law,¹¹ and the bank's security interest will be subordinate to a number of other interests in the collateral including provincial security interests, unless it is perfected in accordance with the applicable Personal Property Security Act.

Most of the true priority rules are directly associated with the registration provisions of the Bank Act. Section 178(4) subordinates a bank's security interest should the bank fail to register a notice of intention in the Bank Act registry. An unregistered section 178 security interest is "void as against creditors of the person giving the security and as against subsequent purchasers or mortgagees in good faith of the property covered by the security". This subordination to subsequent parties cannot be cured by late registration;¹² and the security interest is rendered entirely void if the bank registers a certificate of release.¹³ A prior mortgagee is not considered a "subsequent mortgagee" even though his security agreement contains an after-acquired property clause and the property in question was acquired by the debtor after the creation of the bank's security interest.¹⁴ However, if the prior mortgagee has made a subsequent advance after the creation of the bank's security interest, it is to be considered a subsequent mortgagee to the extent of that advance.¹⁵

If a notice of intention has been registered, the priority position of a section 178 security interest is determined in accordance with sections 178(2) and 179(1). Section 178(2) provides:

- (2) Delivery of a document giving security on property to a bank under the authority of this section vests in the bank in respect of the property therein described
 - (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, the following rights and powers, namely,

¹¹ *Halsted v. Bank of Hamilton* (1896), 27 O.R. 435, at p. 440 (Ont. H.C.); *Young v. Dencher*, [1923] 1 W.W.R. 136 (Alta. App. Div.).

¹² *Canadian Imperial Bank of Commerce v. 281787 Alberta Ltd. (Crockett's Western Wear)*, [1984] 5 W.W.R. 282 (Alta. C.A.).

¹³ *Re Weiss Air Sales Ltd.* (1982), 134 D.L.R. (3d) 706 (Ont. H.C.), aff'd. 140 D.L.R. (3d) 576 (Ont. C.A.). In order to subordinate voluntarily its section 178 security interest the bank should enter into a subordination agreement: the bank cannot release and then reinstate its security interest under the Bank Act.

¹⁴ *Liquid Carbonic Co., Ltd. v. Rountree*, [1924] 1 D.L.R. 1092 (Ont. App. Div.), dealing with similarly worded provincial legislation.

¹⁵ *Grouse Mountain Resorts Ltd. v. Bank of Montreal* (1960), 25 D.L.R. (2d) 371 (B.C.S.C.).

(c) . . . the same rights and powers as if the bank had acquired a warehouse receipt or bill of lading in which such property was described . . .

Under section 186(2), the acquisition of a warehouse receipt or bill of lading vests in the bank "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". Paragraphs (a) and (b) of section 178(2) identify the property to which the bank's interest attaches. Attachment occurs when the debtor becomes the owner of the goods. Thus if the debtor is merely a bailee or lessee of the goods, the bank's interest will not attach.¹⁶ However, the interest of a buyer under a conditional sales agreement is sufficient to constitute the buyer an owner for the purposes of this provision.¹⁷

The effect of a section 178 security interest is not determined by paragraphs (a) and (b), but rather by paragraphs (c) or (d). Upon attachment of the interest, the bank is in the same position as if a bill of lading covering the goods had been immediately transferred to it.¹⁸ If the bank's customer has legal title, the bank acquires it; if the debtor does not have legal title, then the bank will obtain whatever right is possessed by the debtor. The position of the bank is, in many respects, not unlike that of a mortgagee.¹⁹

Section 179(1) creates two additional priority rules. It provides that the bank's security has priority over:

. . . all rights subsequently acquired in, or in respect of such property, and also over the claim of any unpaid vendor, but this priority does not extend over the claim of any unpaid vendor who had a lien on the property at the time of the acquisition by the bank of the warehouse receipt, bill of lading or security, unless the same was acquired without knowledge on the part of the bank of such lien. . . .

¹⁶ See, e.g., *Port Royal Pulp & Paper Co. Ltd. v. Royal Bank of Canada*, [1941] 4 D.L.R. 1 (P.C.).

¹⁷ *Royal Bank of Canada v. Hodges*, *supra*, footnote 9.

¹⁸ Section 178(2)(d) further provides that in certain cases the bank also obtains a first and preferential lien. This device is used to ensure priority over other parties with interests in land where the bank's security interest is in crops, forestry products or goods that become affixed to the land. Section 178(2)(d) must be read together with subsection 179(2) which requires the registration of this interest in the proper land registry or land titles office. The Bank Act provides for the creation of an interest in land to which the goods are affixed because provincial law generally allows only interests in land to be registered under land registry or land title systems.

¹⁹ Davis J. in *Royal Bank of Canada v. Workmen's Compensation Board of Nova Scotia*, [1936] S.C.R. 560, at p. 567 stated: ". . . the security did not operate to transfer absolutely the ownership in the goods but that the transaction was essentially a mortgage transaction and subject to the general law of mortgages except where the statute has otherwise expressly provided".

²⁰ S.C. 1944-45, c. 30, s. 89(1).

This statutory subordination of subsequently acquired rights is unnecessary where competition with a provincial security interest is involved, since it is implicit in section 178(2). Because the bank obtains the debtor's right and title to the goods the moment the debtor obtains ownership, the bank will on this basis be entitled to priority over all subsequent security interests. The portion of section 179(1) referring to subsequent rights was added in 1944²⁰ to protect the security system from the encroachment of provincial statutory liens that were given priority over prior security interests.²¹

The portion of subsection 179(1) that subordinates claims of unpaid vendors is more obscure. Its original purpose was to ensure that a pledgee of documents of title obtained priority over a prior unpaid seller's lien unless the pledgee had notice of the lien.²² Its provincial counterpart can be found in Sale of Goods Acts.²³ The Bank Act of 1890 created a unique federal non-possessory security device.²⁴ The statutory subordination of the unpaid seller's lien which was enacted in 1861 was extended to this new Bank Act security device.²⁵ There is recent judicial authority for the view that the provision refers only to the non-consensual unpaid seller's lien provided in Sale of Goods Acts, and should not be interpreted as including a seller under a conditional sales agreement.²⁶ The legislative history of the Bank Act supports this view. Nor should it apply to the

²¹ See *Royal Bank of Canada v. Workmen's Compensation Board of Nova Scotia*, *supra*, footnote 19. It does not appear that the amendment has had the desired effect: see *Re Johnson Exports Ltd., Ex parte Canada Creosoting Co. Ltd.* (1962), 39 D.L.R. (2d) 95 (B.C.S.C.); *Canada Trust Company v. Cenex Limited*, [1982] 2 W.W.R. 361 (Sask. C.A.); *Royal Bank of Canada v. Erdman*, [1986] 1 W.W.R. 733 (Sask. Q.B.).

²² The provision was included in an 1861 amendment (24 Vict., c. 23) to the Bank Act that permitted the banks to take a pledge of bills of lading and warehouse receipts as security for advances.

²³ R.S.O. 1980, c. 462, s. 45; R.S.S. 1978, c. S-1, s. 46(2). See also, *Mercantile Law Amendment Act*, R.S.O. 1980, c. 265, s. 12.

²⁴ 53 Vict., c. 31, ss. 74-75.

²⁵ One may speculate that the extension of the priority over unpaid vendors to the non-possessory device merely betrays the early origins of the device, arising as it did out of the documentary pledge. Many of the provisions which formerly governed the pledge of documents of title were simply extended to the section 74 device (the ancestor of the section 178 security interest). This may have been done without much consideration for the consequences, since the bank's priority over an unpaid seller who has retained possession of the goods seems quite unfair. The bank is in no way prejudiced or misled as it would be had it actually acquired a warehouse receipt or bill of lading covering the goods. Perhaps the provision was included to cut back on the more extensive civil law right of revendication: see R.A. Macdonald, *loc. cit.*, *supra*, footnote 1, at pp. 1054-1060. But, on the other hand, the drafting of section 179(1) does not reveal a particular sensitivity for civil law concepts.

²⁶ *Rogerson Lumber Co. Ltd. v. Four Seasons Chalet Ltd.*, *supra*, footnote 8, per Houlden J.A. at p. 682.

rights of a seller who has a purchase-money security interest. A security interest created under a Personal Property Security Act is not technically a lien, notwithstanding frequent use of this term by American experts to describe a security interest under Article 9 of the Uniform Commercial Code.

II. *Resolution of Priority Competitions with Provincial Security Interests*

Although the Bank Act contains provisions that govern priority disputes, these provisions are not a sufficient source of law to resolve all priority disputes. Section 178(2) provides that the bank obtains all right and title of the borrower in the collateral, but by implication leaves it to the law of property to determine the consequences of holding such an interest. A very different priority regime prevails under a Personal Property Security Act. Priorities are not determined by property law concepts, but by sets of internal priority rules that are linked to registration and other methods of perfection.²⁷ Consequently, in order to resolve a priority dispute between a section 178 security interest and a Personal Property Security Act interest, it is necessary to characterize the provincial security interest in terms of property concepts. Only then can the Bank Act priority provisions be applied.

A. *Characterization of a Personal Property Security Act Security Interest*

It is tempting to try to resolve a priority conflict between a section 178 security interest and a Personal Property Security Act security interest simply by ignoring altogether the existence of Personal Property Security Acts and applying pre-reform concepts.²⁸ This temptation will be particularly great where the provincial security agreement takes the form of a traditional device such as a conditional sales agreement, a chattel mortgage or a floating charge. The temptation should be resisted since at best it provides a limited, short term solution. Security agreements increasingly being used in jurisdictions which have enacted Personal Property Security Acts frequently make no mention of title retention or transfer. An attempt in this context to find direct analogies in pre-reform security agreements such as floating charges, chattel mortgages and conditional sales contracts, will fail. It is unrealistic to ignore the fundamental changes to provincial personal property security law brought about by the new legislation. Old concepts and forms have been replaced; title is no longer relevant. What is relevant is that a security interest has been created.

²⁷ See, e.g., O.P.P.S.A., ss. 21, 28, 35.

²⁸ This was the approach taken by the Ontario Court of Appeal in *Rogerson Lumber Co. Ltd. v. Four Seasons Chalet Ltd.*, *supra*, footnote 8.

Although the internal priority rules of a Personal Property Security Act cannot be invoked as a means of resolving a priority competition between a section 178 security interest and a Personal Property Security Act security interest, it does not follow that a provincial security interest does not have existence outside these priority rules. A Personal Property Security Act creates a system of law under which the secured party may by agreement obtain real rights in the debtor's property. These real rights come into existence when the security interest attaches, and because they are sanctioned by provincial statute, they should be considered to be of a legal nature.²⁹

It follows, therefore, that whenever possible a priority dispute between a provincial security interest and a section 178 security should be resolved by application of the common law principle of *nemo dat quod non habet*: a man cannot transfer a better title than he himself possesses. A provincial security interest under a Personal Property Security Act is a statutory legal interest in the collateral.³⁰ Since a subsequent section 178 security interest will only attach to the debtor's interest in the property, the bank will take subject to the legal interest acquired under provincial law. The bank acquires the property diminished to the extent of the previous grant. When a section 178 security is taken first, the bank obtains all right and title of the debtor. A subsequent Personal Property Security Act security agreement creates a legal interest that operates only in respect of the debtor's interest in the collateral. Accordingly, a subsequent provincial security interest will take subject to a prior section 178 security.

The *nemo dat* rule does not, however, provide a solution in all situations.³¹ There are two types of priority disputes for which the rule is inadequate: competitions in respect of after-acquired property, and competitions involving purchase-money security interests.

B. Disputes Involving After-Acquired Property

The common law did not generally recognize the automatic transfer of an interest in after-acquired property. A new act of transfer was required

²⁹ The Official Comment to 9-204, Uniform Commercial Code, Official Text (9th ed., 1978) points out that "the security interest in after-acquired property is not merely an 'equitable' interest". It is to be afforded "equal status with a security interest in collateral in which the debtor has rights at the time value is given under the security agreement".

³⁰ A limited legal interest in goods could only be created at common law by the taking of possession (for example, by pledge). Professor R.M. Goode, *Commercial Law* (1982), p. 65 notes that this is because "the doctrine of indivisibility of legal ownership precludes a limited legal interest from being created derivatively out of an existing legal interest". A limited interest in goods arising otherwise than by possession could only take effect in equity. A Personal Property Security Act reverses this position. A statutory (and therefore legal) system of law exists in which a limited interest may be created.

³¹ The *nemo dat* rule was applied in a competition between a Bank Act security interest and a "contractual lien": see *Bank of Montreal v. Guaranty Silk Dyeing & Finishing Co.*, [1935] 4 D.L.R. 483 (Ont. C.A.).

upon the acquisition of the property by the debtor.³² The earlier versions of the Bank Act observed this common law rule: a Bank Act security agreement operated in much the same way as a legal mortgage in that a security interest could be granted only in existing property of the debtor. In 1944 the Bank Act was amended so as to allow a debtor to grant security in after-acquired property,³³ and this change is now reflected in paragraphs 178(2)(b) and (c) of the current Act which displace the common law rule. The moment the debtor obtains ownership of after-acquired property, the bank is vested with all right and title of the debtor, including legal title should the debtor possess it, without any new act of transfer. Personal Property Security Acts also reject the common law in this respect. A security interest may be granted in after-acquired property, and it attaches automatically when the debtor acquires rights in the property.³⁴ Consequently, where both a provincial security agreement and a section 178 security create a security interest in after-acquired property, the resulting priority dispute cannot be resolved by the *nemo dat* rule because both interests arise simultaneously. Some other rule must be applied.

A claim to priority by a bank on the basis of federal paramountcy is not compelling. The Bank Act contains no provision indicating how such a priority dispute is to be resolved. There is no conflict between federal and provincial law, but rather a hiatus in the rules that order priorities.³⁵ It might be argued that because the interests attach simultaneously, each party has a *pro rata* interest in the after-acquired property. Another approach, and the one favoured by the authors, is to award priority to the first party to enter into a security agreement.³⁶ When a similar dispute arises between equitable charges or mortgages, equity awards priority to the holder of the agreement which was first executed: *qui est in tempore potior est jure*. The principle underlying this rule is the idea that a present though inchoate security interest arises when an agreement is executed. Professor Goode has described its theoretical basis:³⁷

Here we have a striking example of the intellectual subtlety of the common law. In a number of cases the courts have ruled that whilst, in a sense, an agreement

³² *Lunn v. Thornton* (1845), 1 C.B. 379, 135 E.R. 587, 14 L.J.C.P. 161 (C.P.).

³³ S.C. 1944-45, c. 30, s. 88(2)(b), now s. 178(2)(b).

³⁴ O.P.P.S.A., s. 13(1); S.P.P.S.A., s. 13(1).

³⁵ R.A. Macdonald, *loc. cit.*, *supra*, footnote 1, at p. 1032 makes the point that the Bank Act "is silent as to the case where the bank acquires its rights simultaneously with another creditor. It follows that the respective priority of creditor and bank in such a situation *must fall to be determined by provincial law*". The problem, of course, is that provincial law in the past never had to develop a priority rule for disputes between two legal interests in the same asset that arise simultaneously.

³⁶ See T.H. Jackson and A.T. Kronman, *Secured Financing and Priorities Among Creditors* (1979), 88 Yale L.J. 1143 for the economic arguments favouring a first in time rule.

³⁷ *Legal Problems of Credit and Security* (1982), p. 7.

for security over after-acquired property cannot attach to that property prior to acquisition, yet the agreement constitutes a *present* security. In other words, it creates an inchoate security interest which is waiting for the asset to be acquired so that it can fasten on to the asset but which, upon acquisition of the asset, takes effect *as from the date of the security agreement*. Acquisition of the asset produces the situation in which the security is deemed to have continuously attached to the asset from the time of execution of the security agreement. This may seem metaphysical but has its counterpart in other branches of law.

A first in time priority rule has also been applied in a priority dispute between two banks each claiming section 178 security interests in after-acquired property.³⁸

It must be admitted, however, that unless accompanied by an effective registry system, a first in time priority rule has little value to a lender who wishes to assess his priority position before granting credit to a customer. Without the ability to determine whether another lender has already entered into a security agreement with the customer, a lender takes the risk that his security agreement with the borrower is not the first to be executed. Since the failure to perfect a Personal Property Security Act security interest has no significance outside the priority rules of a Personal Property Security Act, the first in time priority rule will not produce efficient or desirable results. An effective first in time rule is dependent upon an effective registry system. What is required is an expansion of the priority structure of Personal Property Security Acts, or an amendment to the Bank Act that relates first in time priority to registration where a section 178 and a Personal Property Security Act security interest are involved, just as it now does where two section 178 security interests are involved.

C. Disputes Involving Purchase-Money Security Interests

A section 178 security interest covering after-acquired property may come into competition with a provincial purchase-money security interest.³⁹ Prior to the enactment of the Personal Property Security Acts, this type of dispute would have arisen in the form of a competition between a section

³⁸ *Royal Bank of Canada v. Bank of Montreal*, [1976] 4 W.W.R. 721 (Sask. C.A.). It might be argued, however, that this result was dictated by the wording of s. 178(2)(b), rather than by the application of property law principles.

³⁹ The Ontario Personal Property Security Act in s. 1(s) defines a "purchase-money security interest" as a security interest that is:

- (i) taken or reserved by the seller of the collateral to secure payment of all or part of its price, or
- (ii) taken by a person who gives value that enables the debtor to acquire rights in or the use of collateral, if such value is applied to acquire such rights.

Subclause (i) will generally apply to sellers, while subclause (ii) will apply to lenders who make purchase-money loans.

178 security interest and the interest of a seller under a subsequent conditional sales agreement. Priority would have been given to the conditional seller because he retained legal title until the full purchase price was paid. The bank's security interest would attach only to the limited interest of a conditional buyer.

The position under the Ontario Personal Property Security Act was considered by the Ontario Court of Appeal in *Rogerson Lumber Co. Ltd. v. Four Seasons Chalet Ltd.*⁴⁰ The dispute was between a Bank Act security interest and an unperfected security interest taken under a conditional sales agreement. A majority of the court simply applied basic property law, which generally gives priority to a conditional seller because he holds legal title. The primary issue before the court was whether or not the Ontario Personal Property Security Act subordinated the conditional sales agreement because it was not perfected by registration. A majority held that it did not. However, in the very recent decision of the Saskatchewan Court of Queen's Bench in *J.I. Case Credit Corporation v. Canadian Imperial Bank of Commerce*,⁴¹ Matheson J. took the position that priority of a conditional seller's interest over the section 178 security interest can no longer be based upon a theory of title retention because a "reservation of title unto a conditional vendor has no particular significance under personal property security legislation".⁴² Of the two positions, that taken by Matheson J. is to be preferred. Since title retention or title transfer is not relevant to the creation of security interests under a Personal Property Security Act, reliance on title as the key consideration in resolving priority disputes where purchase-money security interests are involved will be futile in a growing number of situations in which a Personal Property Security Act security agreement makes no mention of legal title.

The rejection of title as the determining factor in resolving priority disputes between section 178 security interests and Personal Property Security Act purchase-money security interests does not dictate the conclusion that the priority rules of a Personal Property Security Act must be employed. If, as is suggested by the authors of this article, the priority system of a Personal Property Security Act does not apply to priority disputes involving section 178 security interests, the special priority given to a purchase-money security interest by the provincial legislation cannot be the basis for giving it priority over section 178 security interests. Consequently, a different approach must be employed.

⁴⁰ *Supra*, footnote 8.

⁴¹ (1985), 45 Sask R. 74 (Sask. Q.B.).

⁴² *Ibid.*, at p. 77.

English commercial law has struggled with the question as to whether or not there exists a special status for a purchase-money security interest granted to a lender. Professor Goode has outlined the law that has emerged:⁴³

Unfortunately, English law has never recognised the priority of the purchase-money security interest as such. Instead, the courts have examined the sequence of operations with meticulous detail to find out whether the debtor's interest in the asset was encumbered at the outset by the purchase-money mortgage (in which case A's after-acquired property clause can attach to the asset only in its encumbered form, so that B [the lender of the funds for the purchase of the after-acquired property] wins) or whether on the other hand there was a moment of time (*scintilla temporis*) in which . . . [the debtor] was the unencumbered owner of the asset before granting the purchase-money security interest, in which event A's after-acquired property clause flashes in to catch the asset seconds before the purchase-money security interest takes effect.

A similar approach might be adopted when dealing with a purchase-money security interest arising under a Personal Property Security Act. The creation of a Personal Property Security Act security interest does not require a transfer of title or property interest by the debtor to the secured party or retention of title by a seller.⁴⁴ Because no transfer of rights is necessary, a purchase-money security interest granted to a lender arises immediately. The transaction does not involve the acquisition of the unencumbered ownership of the goods followed by a transfer of an interest to the secured party. Instead, the rights of the debtor are *ab initio* subject to the purchase-money security interest. Because the debtor at no point acquires unencumbered ownership of the goods which are subject to the purchase-money security interest, a bank holding a section 178 security interest acquires merely the debtor's encumbered interest.⁴⁵ Section 179(1) does not improve the bank's position. The provision ensures that the rights obtained by the bank under section 178(2) are given priority over subsequently acquired rights. But under section 178(2) the bank from the outset obtains only the encumbered interest of the debtor. The purchase-money financier, however, must ensure that a security agreement has been executed prior to the debtor's acquisition of rights in the collat-

⁴³ *Op. cit.*, footnote 37, p. 56. In the quotation set out in the text, the original reads, immediately after (*scintilla temporis*): "in which B was the unencumbered owner . . .". It is suggested that the reference should not be to B, but to "the debtor". The quotation has been amended accordingly. See also *Re Connolly Brothers Ltd. (No. 2)*, *Wood v. The Company*, [1912] 2 Ch. 25, 81 L.J. Ch. 517 (C.A.); *Security Trust Co. v. Royal Bank of Canada*, [1976] A.C. 503, [1976] 1 All E.R. 381 (P.C.).

⁴⁴ O.P.P.S.A., s. 2(a); S.P.P.S.A., s. 3.

⁴⁵ A similar analysis is employed under pre-P.P.S.A. law in a competition between a general assignment of book debts and a subsequent inventory financier who claims the proceeds of the sale of inventory under a proceeds clause. The debtor *ab initio* obtains an interest in the account subject to the agreement to hold it in trust. As a result it has nothing to assign to the accounts financier. See: *Borg-Warner Acceptance Canada Ltd./Ltée. v. Mercantile Bank of Canada*, [1985] 5 W.W.R. 605 (B.C.C.A.); *Royal Bank of Canada v. General Motors Acceptance Corp. of Canada Ltd.* (1985), 18 D.L.R. (4th) 201 (N.S. App. Div.).

eral, since the time of attachment of the security interest will be delayed until this requirement is met.⁴⁶

This argument may, however, be difficult to maintain given the wording of the applicable provisions of Personal Property Security Acts. Section 34(2) of the Ontario Act provides that if the appropriate perfection steps are taken, a purchase-money security interest in collateral has "priority over any other security interest in the same collateral". Clearly the *raison d'être* for recognizing this unique type of security interest is to give a special priority to certain types of credit grantors holding Personal Property Security Act security interests. It is therefore difficult to dissociate the purchase-money status from the priority system of the Act. Apart from this system, a purchase-money security interest is no different in essential nature from any other security interest. If this is accepted, priority between a section 178 security interest arising under a prior agreement and a Personal Property Security Act purchase-money security interest would be governed by the first in time priority rule discussed above. This creates few difficulties for a prospective purchase-money financier since he will be able to determine through the Bank Act registry whether or not there exists a section 178 security agreement to which he will be subordinate if he grants credit to the debtor.

A competition may also arise between a provincial security interest in after-acquired property and a subsequent section 178 security interest granted to the bank to secure a purchase-money loan. This question was briefly addressed in the Saskatchewan Court of Queen's Bench decision of *Leoville Savings and Credit Union Limited v. Campagna*.⁴⁷ The competition was between a credit union claiming under an after-acquired property clause in a chattel mortgage and a bank holding a section 88 security. Each agreement provided for a security interest in pigs. The pigs in dispute were purchased with money advanced by the bank. Disbery J., *in obiter*, stated:⁴⁸

So far as such pigs are concerned . . . they came within the operation of the chattel mortgage as and when Campagna [the debtor] acquired them; but only to the extent that the value of Campagna's equity in them, if any, exceeded the amount of the bank's claim protected by its said security. Put another way, the chattel mortgage attaches to the beneficial interest of the mortgagor in such *subsequently acquired* goods and chattels.

This decision suggests the possibility at least that courts will recognize a purchase-money status for section 178 security interests, thereby giving the bank priority over prior provincial security interests which attach to property acquired with section 178 loans.

⁴⁶ O.P.P.S.A., s. 12(1); S.P.P.S.A., s. 12(1).

⁴⁷ (1970), 75 W.W.R. 66 (Sask. Q.B.).

⁴⁸ *Ibid.*, at p. 69.

D. Tacking of Future Advances

At common law a secured party who makes a future advance without notice that the debtor had given a subsequent security interest is entitled to tack that future advance to his original loan, thereby giving him priority over the intervening party.⁴⁹ Both the Bank Act and the Personal Property Security Act have widened this rule. Section 180(1)(b) of the Bank Act provides that the security secures advances made:

- (b) on the written promise or agreement that a . . . security under section 178 would be given to the bank, in which case the debt, liability, loan or advance may be contracted or made before or at the time of or after such acquisition.

The Saskatchewan Court of Appeal in *Royal Bank of Canada v. Bank of Montreal*⁵⁰ held that this provision permitted a bank to make future advances while preserving priority over an intervening Bank Act security interest. Personal Property Security Acts permit tacking of future advances even though the advances are made with notice of an intervening perfected security interest. The Ontario Act merely permits a security agreement to secure future advances, but does not indicate whether it should be considered to be a separate security interest or a continuing one.⁵¹ The Saskatchewan Act contains a similar provision,⁵² but also contains distinct priority rules that govern future advances.⁵³

Neither the Bank Act nor Personal Property Security Acts address the relative priority position of federal and provincial security interests where one of them secures future advances made after the other comes into existence. If the decision in *Royal Bank of Canada v. Bank of Montreal* applies to priority disputes involving federal and provincial security interests, banks holding section 178 security interests will be allowed to tack future advances. However, if the right to tack given by a Personal Property Security Act is viewed as a priority rule, it will have no application where the holder of a Personal Property Security Act security interest claims priority with respect to future advances over an intervening section 178 security interest. The right to tack under a Personal Property Security Act can, however, be viewed as an aspect of the nature and scope of a Personal Property Security Act security interest. If this view is accepted, the holder of a Personal Property Security Act security interest will be entitled to tack future advances in priority to an intervening section 178 security interest.

⁴⁹ *Hopkinson v. Rolt* (1861), 9 H.L. Cas. 514.

⁵⁰ *Supra*, footnote 38, at p. 730.

⁵¹ O.P.P.S.A., s. 15. See F.M. Catzman, *Personal Property Security Law in Ontario* (1976), pp. 76-82; B. Crawford, *A Practitioner's Notes Upon the Ontario Personal Property Security Act (1975-76)*, 1 C.B.L.J. 269, at p. 308.

⁵² S.P.P.S.A., s. 14.

⁵³ S.P.P.S.A., ss. 20(2), 35(4).

E. *Attempts to Integrate the Priority Rules of Personal Property Security Acts*

The priority-ordering scheme described above presents practical difficulties for banks. Under this scheme, a bank may find that its section 178 security interest is subordinate to an unregistered provincial security interest arising under an agreement executed before the section 178 agreement is executed, or coming into existence before the section 178 security interest attaches. The bank is faced with the age-old problem of the "secret lien".

The courts, for this reason, may be tempted to apply the internal priority rules of a Personal Property Security Act in order to subordinate a prior unperfected provincial security interest.⁵⁴ One method by which this could be accomplished is to force a marriage between the provisions of the Bank Act and a Personal Property Security Act. When the Bank Act security interest attaches, the bank obtains "the same rights and powers as if the bank had acquired a warehouse receipt or bill of lading in which such property was described". Under a Personal Property Security Act, possession of a negotiable document of title is sufficient to perfect a security interest in the goods.⁵⁵ The internal priority rules of a Personal Property Security Act will be available if the bank is treated as if it were a holder of a document of title for the purposes of provincial law as well. The failure of the Ontario Court of Appeal to take this approach in *Rogerson Lumber Co. Ltd. v. Four Seasons Chalet Ltd.* has been lamented:⁵⁶

Under subsection 31(1) or 28(2) of the P.P.S.A., if the bank had actually been the holder of a bill of lading or warehouse receipt its security interest in such a document of title would have taken priority over the unperfected purchase money security interest of the customer. If the court had given the bank the same rights by virtue of the competent federal law deeming it to have the status of a holder of a document of title, the decision would have done less violence to either statute and would have accorded more closely with common expectations of bankers, businessmen and lawyers.

Integration of the two systems in this fashion is highly artificial. There were historically two separate spheres of law governing the pledge of documents of title. The predecessors of section 186 of the Bank Act regulated a pledge of documents of title given to a bank, while provincial law regulated a pledge of documents of title given to other parties. In the beginning, the province of Ontario made an effort to duplicate the federal

⁵⁴ Matheson J. in *J.I. Case Credit Corporation v. Canadian Imperial Bank of Commerce*, *supra*, footnote 41, appears to have applied s. 35 of the Saskatchewan Personal Property Security Act to resolve a priority question between a Bank Act security interest and a provincial security interest.

⁵⁵ O.P.P.S.A., s. 24; S.P.P.S.A., s. 24.

⁵⁶ B. Crawford, *op. cit.*, footnote 1, p. 15.

provisions, but in time the two systems drifted apart.⁵⁷ The enactment of Personal Property Security Acts has introduced significant changes to provincial systems, and they are now very different from the federal system. In 1967, the Bank Act was amended so as to permit banks to take security under the provincial system as well. Presumably a bank may now elect to be governed by the provincial system when documents of title are actually pledged to it. However, when section 178(2) of the Bank Act refers to the holders of bills of lading and warehouse receipts, it is undoubtedly referring to the federal system set out in section 186 of the Bank Act, and not to any provincial system. The reference in section 178(2) to the rights of holders of bills of lading and warehouse receipts therefore does not invite the application of a Personal Property Security Act. In any event, in order for a party to have a perfected Personal Property Security Act security interest in goods covered by a document of title, the goods must be in the hands of a bailee, and not the debtor.⁵⁸ Nor can the bank be a holder of a document of title so as to bring the transaction within those provisions of Personal Property Security Acts which give a special status to holders of negotiable documents of title.⁵⁹ Surely these provisions apply to persons who actually hold negotiable documents of title and not to those who are deemed to hold them under federal law.

The only reason for adopting such an artificial approach is that it would allow a bank to resort to the internal priority rules of a Personal Property Security Act in order to subordinate an unperfected Personal Property Security Act security interest. But the problems created by this approach would far outweigh the benefits. As indicated in the next portion of this article, the application of the priority provisions of a Personal Property Security Act to a section 178 security interest would produce chaotic results. The problem calls for a legislative solution. One possibility is to add to each Personal Property Security Act a provision expressly subordinating an unperfected security interest to a Bank Act security interest.⁶⁰ Alternatively, it could take the form of an additional Bank Act priority rule.⁶¹

⁵⁷ See R.J. Wood, *The Pledge of Documents of Title in Ontario* (1984), 9 C.B.L.J. 81, at pp. 91-92.

⁵⁸ O.P.P.S.A., s. 28(2)(a) and (c); S.P.P.S.A., s. 27(1)(a) and (d).

⁵⁹ O.P.P.S.A., s. 31(b); S.P.P.S.A., s. 31(4).

⁶⁰ Such a provision could be added for example to O.P.P.S.A., s. 22(1) and to S.P.P.S.A., s. 20, which subordinate an unperfected security interest to certain non-P.P.S.A. interests.

⁶¹ A similar subordination of unregistered provincial interests by federal law may be found in s. 72 of the Bankruptcy Act, R.S.C. 1970, c. B-3 which subordinates unregistered assignments of book debts to the trustee in bankruptcy.

III. Registration of Section 178 Security Interests in Personal Property Security Act Registries

The decision of the Ontario Court of Appeal in *Rogerson Lumber Co. Ltd. v. Four Seasons Chalet Ltd.*⁶² has caused some banks to adopt the practice of registering financing statements relating to section 178 security interests in personal property registries. Presumably a bank does so in order to invoke the priority rules of the Personal Property Security Act should it come into competition with an unperfected provincial security interest. The obvious difficulty facing the bank when seeking to establish rights under provincial law is that it must demonstrate that a section 178 security interest is a "security interest" within the meaning of a Personal Property Security Act.⁶³

Nothing prevents a provincial legislature from including a section 178 security interest within the scope of its legislation. Pre-reform chattel registration statutes permitted a holder of a Bank Act security interest to take advantage of provisions which subordinated unregistered conditional sales contracts and chattel mortgages.⁶⁴ However, the Ontario Court of Appeal in *Rogerson Lumber Co. Ltd. v. Four Seasons Chalet Ltd.*⁶⁵ concluded that the Ontario Personal Property Security Act is less generous to the banks. A majority of the court concluded that the Ontario Legislature did not intend to include a section 178 security interest as "an interest . . . entitled to priority under this or any other Act" when it enacted section 22(1)(a)(i). Although this case might be confined to the interpretation of section 22(1)(a)(i) of the Ontario Act, it certainly suggests a wider approach. This approach proceeds from the premise that a section 178 security interest is not a "security interest" to which a Personal Property Security Act applies, and consequentially the priority rules of such an Act do not apply to it.⁶⁶ An examination of the priority provisions of a Personal Property Security Act supports this view.

⁶² *Supra*, footnote 8.

⁶³ O.P.P.S.A., s. 1(y); S.P.P.S.A., s. 2(nn).

⁶⁴ See *Royal Bank of Canada v. Hodges*, *supra*, footnote 9; *Grouse Mountain Resorts Ltd. v. Bank of Montreal*, *supra*, footnote 15; *Leoville Savings and Credit Union Ltd. v. Campagna*, *supra*, footnote 47; *Re J.D. Dudar and Sons* (1982), 43 C.B.R. (N.S.) 61 (Alta. Q.B.).

⁶⁵ *Supra*, footnote 8, per Arnup J.A. at pp. 679-680.

⁶⁶ It does not follow from this that the legislature of a jurisdiction which has enacted a Personal Property Security Act should be seen as precluding the holder of a section 178 security interest from having any rights under the Act. In the *Rogerson* case, a majority of the court (see Arnup J.A. at p. 680 and Houlden J.A. at pp. 680-681) accept that the holder of a section 178 security agreement can be a third party against which an unwritten P.P.S.A. security interest is unenforceable under section 10 of the Ontario Act. While section 10 may be viewed as a priority rule, its application where a section 178 security interest is involved does not require one to conclude that the bank holds a P.P.S.A. security interest, nor does it result in circumvention or frustration of the policies on which the Act is based.

The priority rules of Personal Property Security Acts differ markedly from the priority rules of legislation which these Acts replaced. The basic priority rule common to all Personal Property Security Acts focusses on the time of registration: priority goes to the secured party who first registers a financing statement, even though he is not the first to execute a security agreement with a debtor or to acquire an attached security interest in the collateral.⁶⁷ The policy underlying this approach is quite simple. Once a financing statement is registered⁶⁸ any person who is planning to deal with someone named as debtor in the financing statement has the ability to determine whether or not the interest he intends to acquire will be subject to a security interest having a prior status. If such a person goes ahead and acquires an interest in the personal property described in the financing statement without making some accommodation with a registering party⁶⁹ or without obtaining a discharge of the financing statement,⁷⁰ there is no reason to give his interest priority over a subsequent security interest acquired by the registering party.

The policy of a Personal Property Security Act would be frustrated in this regard if a section 178 security interest were treated as a "security interest": A section 178 security interest can never be subject to a Personal Property Security Act priority rule which withdraws rights given by the Bank Act.⁷¹ The Bank Act gives a section 178 security interest priority over a subsequent Personal Property Security Act security interest, and this rule will govern notwithstanding that the provincial interest holder may have been the first to register. Thus, in the case of a secured party who registers first, but whose Personal Property Security Act security interest attaches after the section 178 security interest arises, the bank could avoid the first to register priority rule simply by asserting its rights under the Bank Act.⁷²

The absurdity of bringing section 178 security interests into the priority structure of a Personal Property Security Act can be further

⁶⁷ O.P.P.S.A., s. 35(1); S.P.P.S.A., s. 35(1).

⁶⁸ In most provinces a financing statement can be registered before a security agreement is registered. See, e.g., S.P.P.S.A., s. 44(2).

⁶⁹ Under all Personal Property Security Acts information concerning the nature and extent of a secured party's interest can be obtained directly from the secured party by request through the debtor. See O.P.P.S.A., s. 20; S.P.P.S.A., s. 18.

⁷⁰ See S.P.P.S.A., s. 50, which allows the person named as debtor to have the registration lapsed.

⁷¹ In *Rogerson Lumber Co. Ltd. v. Four Seasons Chalet Ltd.*, *supra*, footnote 8, Arnup J.A. at p. 677 stated: "The P.P.S.A. cannot prejudicially affect the Bank's interest, acquired pursuant to a federal statute."

⁷² The decision of *Moose Jaw v. Pulsar Ventures* (1986), 43 Sask. R. 247 (Sask. Q.B.), involved the registration of a section 178 security interest in the personal property registry. Hill J. invoked the Personal Property Security Act to subordinate the bank's claim, but suggested that the bank would have been able to obtain priority under section 179(1) had the provincial security interest been a subsequent interest.

demonstrated. Under section 20(2) of the Saskatchewan Personal Property Security Act, a secured party who makes future advances on the security of collateral after becoming aware of seizure of the collateral under a judgment enforcement measure, cannot tack the advances so as to gain priority over the judgment creditor to the extent of those advances. There is no equivalent priority rule in the Bank Act.⁷³ Accordingly, a bank which has taken a section 178 security interest but has registered a financing statement in the Saskatchewan Personal Property Registry could circumvent the effect of section 20(2) of the Saskatchewan Act by asserting its federal rights. Similarly, other special priority rules such as those dealing with ordinary course buyers⁷⁴ and consumer buyers⁷⁵ could be ignored at will by a bank.⁷⁶

If a section 178 security interest were to be treated as a "security interest" under Personal Property Security Acts, banks adopting the practice of dual registration of a section 178 security interest would be permitted to obtain the benefits of provincial systems without having to accept any of their burdens. They would be permitted to circumvent at will the policies underlying the priority rules of Personal Property Security Acts, and provincial systems would be thrown into chaos. Any provincial legislature that intended to include section 178 security interests within the scope of a Personal Property Security Act must also have intended to be excessively generous to chartered banks at the expense of other secured creditors, unsecured creditors, good faith buyers and other persons whose interests are affected by a Personal Property Security Act. There are no commercial or political reasons for such generosity.

The highly integrated structure of a Personal Property Security Act and the special policies which such legislation is designed to implement support the view that a section 178 security interest was never intended to be a "security interest" to which a Personal Property Security Act applies.⁷⁷ Accordingly, the registration of a financing statement in a personal property registry respecting a section 178 security interest should be treated as having no legal effect.⁷⁸

⁷³ See *Royal Bank of Canada v. Bank of Montreal*, *supra*, footnote 38. It is assumed that the approach taken in this case can be extended to a situation where an intervening unsecured creditor is involved.

⁷⁴ O.P.P.S.A., s. 30(1); S.P.P.S.A., s. 30(1).

⁷⁵ S.P.P.S.A., s. 30(2).

⁷⁶ However, it may not be able to circumvent the special priority position of a purchase-money security interest. See text accompanying footnote 39.

⁷⁷ Note also *Johnson v. Bank of Nova Scotia*, *supra*, footnote 7, in which the court held that a section 178 security interest is not a "security interest" within the meaning of The Exemptions Act, R.S.S. 1978, c. E-14.

⁷⁸ Some commentators have suggested that by registering its interest in the personal property registry a bank accepts provincial jurisdiction over the security interest, so that

IV. Overlapping Section 178 and Personal Property Security Act Agreements

It is a growing practice for a bank to require its customer to execute both a Personal Property Security Act security agreement and a section 178 security agreement covering the same collateral to secure the same obligation.⁷⁹ This practice apparently is designed to permit the bank to invoke the system of law most favourable to it whenever a threat to its position as a secured creditor arises. The Bank Act does not prohibit a bank from entering into a security agreement governed by provincial law. Nor is the holding of a Personal Property Security Act security interest by a bank a bar to the acquisition by that bank of a section 178 security interest in the same collateral. Nevertheless, the use of overlapping federal and provincial security interests in the same collateral creates considerable uncertainty.

There are two common law principles which may apply to this practice: merger and election. Merger of securities involves a presumption that when a party acquires two co-extensive security interests in the same collateral, the benefit of the lower security interest is lost by merger into the higher security.⁸⁰ It is unlikely, however, that the principle of merger can be applied to overlapping Personal Property Security Act and section 178 security interests. Neither security interest is "lower" than the other. In any case, merger is generally a matter of intention. A provision in a security agreement negating merger or indicating that one security interest is supplementary or collateral to the other, or any other evidence tending to show that merger was not intended, will prevent merger at law and in equity.⁸¹ In most cases, evidence against merger is not difficult to find.

Election cannot be so easily dismissed. Although the principle of election cannot readily be reduced to a formula, the most frequently cited

all matters relating to the bank's security interest should be governed by the Personal Property Security Act. See McLaren, *op. cit.*, footnote 1, s. 6.03[1][b][i][B]. It is difficult to see why this should be the case since the bank will also have registered a notice of intention in the Bank Act registry.

⁷⁹ One of the security agreements may be broader in scope so as to provide for a security interest in types or items of collateral not covered by the other security interest. This fact alone does not affect the conclusions reached in this portion of the paper.

⁸⁰ See generally, E.L.G. Tyler, Fisher and Lightwood's Law of Mortgage (9th ed., 1977), pp. 595-598; W.B. Rayner and R.H. McLaren, Falconbridge on Mortgages (4th ed., 1977), pp. 400-408; *La Banque Provinciale du Canada v. Adjutor Levesque Roofing Ltd. et al.* (1968), 68 D.L.R. (2d) 340 (N.B. App. Div.).

⁸¹ *Twopenny v. Young*, [1824-1834] All E.R. Rep. 273 (K.B.); *Commissioner of Stamps v. Hope*, [1891] A.C. 476 (P.C.); *Northern Crown Bank v. Elford & Cornish*, [1917] 2 W.W.R. 109 (Sask. C.A.).

description of the principle is that contained in the judgment of Lord Atkin in *United Australia, Ltd. v. Barclays Bank, Ltd.*:⁸²

[I]f a man is entitled to one of two inconsistent rights it is fitting that when with full knowledge he has done an unequivocal act showing that he has chosen the one he cannot afterwards pursue the other, which after the first choice is by reason of the inconsistency no longer his to choose.

Rough parallels can be found between the use of overlapping federal and provincial security agreements and the assertion of co-extensive federal and provincial rights in other contexts.⁸³ For example, when a maintenance order is obtained in divorce proceedings, the applicant cannot thereafter enforce a right to maintenance under a prior maintenance agreement.⁸⁴

If the principle of election is to be applied to a claim to rights under both a section 178 security agreement and a Personal Property Security Act security agreement, it is necessary to determine at what time and by what act an election is made by the bank. In the words of Lord Atkin, there must be an "unequivocal act" showing that one course is chosen over the other. In the maintenance cases, the application for a maintenance order is generally not considered to be an election; the election is made when the order is obtained.⁸⁵ It is difficult to identify any particular event, prior to the seizure of the collateral,⁸⁶ that indicates a choice by a bank of one system over the other. If the issue involves priorities, seizure may be of no help if it is not the bank that has effected the seizure, or if the dispute arises prior to seizure of the collateral. Registration is equivocal since the bank will register each security interest in the appropriate registry.⁸⁷ It may be that under the principle of election a bank is free to

⁸² [1941] A.C. 1, at p. 30 (H.L.). This formulation was quoted with approval by Kellock J. in *Findlay v. Findlay*, [1951] 4 D.L.R. 769, at pp. 778-779 (S.C.C.). See also *Lissenden v. C.A.V. Bosch, Ltd.*, [1940] 1 All E.R. 425 (H.L.), per Viscount Maugham at pp. 428-430.

⁸³ Of course the principle of election is not confined to situations in which the two sources of rights or remedies are federal and provincial statutes. See, e.g., *Peat Marwick Ltd. v. Consumers' Gas Co.* (1981), 113 D.L.R. (3d) 754 (Ont. C.A.).

⁸⁴ See *Re Finnie and Rae* (1977), 77 D.L.R. (3d) 330 (Ont. H.C.); *Furber v. Furber*, [1973] 1 W.W.R. 742 (B.C.S.C.); *Coburn v. Coburn*, [1971] 4 W.W.R. 555 (B.C.S.C.). See generally, *Findlay v. Findlay*, [1952] 1 S.C.R. 96. See also *R. v. Zelensky*, [1978] 2 S.C.R. 940, at p. 964, in which Laskin C.J.C. suggests that when an order for compensation is obtained under section 653 of the Criminal Code, R.S.C. 1970, c. C-34, the applicant might be found to have elected against civil proceedings to recover against the person who caused the loss or damage.

⁸⁵ *Ibid.*

⁸⁶ See *Peat Marwick Ltd. v. Consumers' Gas Co.*, *supra*, footnote 83. The act of seizure may not itself indicate an election, but compliance or non-compliance with procedural requirements of the applicable Personal Property Security Act should indicate an election. See, e.g., O.P.P.S.A., ss. 58, 59, 61.

⁸⁷ Bank Act, s. 178(4); S.P.P.S.A., s. 44(2).

leave its options open until a third party claim to priority is made, at which point it must make its choice.⁸⁸ Indeed, it is not difficult to imagine an impasse between two banks, each holding a section 178 and Personal Property Security Act security interest, and both reluctant to make an election until the other does.

Even if the principle of election is accepted, its application may, in certain circumstances, be objectionable on public policy grounds. A bank's ability to elect between federal and provincial systems permits it to frustrate at its convenience the legislative policies underlying each system. For example, if the debtor has become a bankrupt and has failed to pay his employees, it is surely against public policy for a bank to elect its rights as a secured creditor under provincial law in order to avoid the subordination provision in section 178(6) of the Bank Act.⁸⁹ No doubt, the bank could have chosen initially to grant credit solely under a Personal Property Security Act agreement and thereby avoid section 178(6); however, it is quite a different matter for a bank to arrange its affairs so as to be in a position to avoid section 178(6) by the mere stratagem of taking a Personal Property Security Act agreement along with its section 178 security agreement. The principle of election should not prevent the court from finding that one or the other security agreement was intended to be the dominant agreement,⁹⁰ and that the bank cannot escape the legislative policies underlying the system governing the dominant agreement by invoking the subsidiary agreement.

The exercise of rights under both the Bank Act and a Personal Property Security Act does not necessarily involve the type of inconsistency that would bring the principle of election into operation. A bank which holds a section 178 security interest and a Personal Property Security Act security interest in the same collateral to secure the same obligation can be seen to be claiming cumulative rights, not unlike those of a mortgagee who has a first and second mortgage on the same property. To the extent that it is possible to have both systems operating in tandem rather than in opposition, the intentions of the parties are more likely to be accommodated. It appears that this is possible in the context of third party priority claims, but not in the context of the exercise of a bank's rights against the debtor in the event of default.

The holder of two mortgages in the same property has, for the purpose of determining his priority position relative to holders of other interests in the property, two different interests. The interest under the

⁸⁸ See B. Wilson, Section 178: Proceed with Caution (1982), 40 C.B.R. (N.S.) 205.

⁸⁹ Section 178(6) provides that where a debtor under a section 178 security agreement becomes a bankrupt, unpaid employees of the debtor have priority to the rights of the bank in respect of claims for wages, salary, or other remuneration earned during the period of three months next proceeding the bankruptcy receiving order or assignment.

⁹⁰ See *Peat Marwick Ltd. v. Consumers' Gas Co.*, *supra*, footnote 83, at p. 758.

second mortgage is the residual interest remaining after the interest created by the first mortgage is subtracted. Accordingly, if a section 178 security interest is taken by a bank, a subsequent Personal Property Security Act security interest in the same collateral attaches only to the debtor's rights in the collateral as encumbered by the section 178 security interest. Under this approach, there is then no conflict between the two systems,⁹¹ and no need to apply the principle of election. Each security interest attaches to a separate quantum of the debtor's interest in the collateral, and each system regulates the priority rights of claims to that particular quantum of interest.

In practical terms, the priority implications of this approach (which is hereafter described as the quantum approach) is that the bank will generally be forced to accept the priority status given to it by the system governing its primary security interest. In effect, the bank will be in the same position as if it elected to pursue its rights exclusively under its primary security interest. However, in some situations the bank may be able to gain an additional advantage through reliance on both security interests.

The operation of the quantum approach is illustrated in the following scenario. A credit union takes a Personal Property Security Act security interest in the debtor's assets, but neglects to perfect its interest by registration. The debtor then gives to a bank a primary section 178 security interest and a subsidiary Personal Property Security Act security interest in the same assets. A notice of intention is registered as required by section 178(4) of the Bank Act, and a financing statement is registered perfecting the bank's Personal Property Security Act security interest. In the event of the debtor's default, the credit union's security interest will have priority over the bank's section 178 security interest.⁹² The fact that the credit union's security interest is subordinate to the bank's Personal Property Security Act security interest under provincial law is relevant only when the obligation secured by the credit union's security interest exceeds the obligation secured by the bank's section 178 security interest. Thus, if the loan made by the credit union was \$15,000 and the loan made by the bank was \$10,000, the credit union will have priority to the first \$10,000. In asserting priority for the additional \$5,000, the credit union's security interest comes into competition with the bank's Personal Property Security Act security interest, to which the credit union's security

⁹¹ This approach would be in line with recent thinking of the Supreme Court of Canada regarding situations where "conflict" between federal and provincial legislation is alleged. See *Re Deloitte, Haskins & Sells Ltd. and Workers' Compensation Board* (1985), 19 D.L.R. (4th) 577 (S.C.C.), per Wilson J. at pp. 592-594.

⁹² *Rogerson Lumber Co. Ltd. v. Four Seasons Chalet*, *supra*, footnote 8, and text accompanying footnotes 28-30, *supra*.

interest is subordinate because of its failure to register. The quantum approach would apply equally to any priority rules of the system governing the bank's primary security interest that give priority to claimants including purchase-money creditors,⁹³ judgment creditors,⁹⁴ and a trustee in bankruptcy⁹⁵ in the case of a primary Personal Property Security Act security interest, and unpaid wage earners and suppliers of agricultural products⁹⁶ in the case of a primary section 178 security interest.

The quantum approach does not ignore the principle of *nemo dat quod non habet* in cases where the third party interest is acquired after both federal and provincial security interests have been taken by a bank. The subsequent interest will have the priority status dictated by the rules of the system governing the bank's primary security interest to the extent of the quantum of interest covered by the bank's primary security interest. The bank will nevertheless be able to rely on the priority given to it by the system governing its subsidiary security interest to the extent that the claim of the competing interest holder exceeds the value of the obligation secured by the primary security interest.

One of the difficulties with the quantum approach is that it requires determining which of the two security interests is primary and which is subsidiary. It is always open to the parties to settle the matter at the date of execution of the agreements.⁹⁷ However, in the absence of direct evidence as to the parties' intentions, circumstantial evidence will have to be relied upon. The sequence of execution of the security agreements may be helpful if it can be determined. If the intentions of the parties cannot be established, the court must employ a presumption in favour of one system over the other. The Bank Act system was designed for and is available exclusively to banks. It is not subject to provincial modification, and therefore is one which applies in all jurisdictions in Canada. The operational efficiency and legal predictability that this affords should lead courts to conclude that, unless a contrary intention is manifested, a bank should be presumed to take a section 178 security agreement as its primary security agreement.

The quantum approach cannot be so readily applied where *inter partes* issues between a bank and the debtor arise. The debtor has given two security interests in his property to secure the same obligation. Each gives to the bank the right, in prescribed events, to seize the collateral, dispose of it and apply the proceeds in total or partial discharge of the

⁹³ O.P.P.S.A., s. 34; S.P.P.S.A., s. 34.

⁹⁴ O.P.P.S.A., s. 22(1)(a)(ii); The Executions Act, R.S.S. 1978, c. E-12, s. 2.2., as amended S.S. 1979-80, c. 24, s. 3.

⁹⁵ O.P.P.S.A., s. 22(1)(a)(iii); S.P.P.S.A., s. 20(1)(d).

⁹⁶ Bank Act, s. 178(6).

⁹⁷ See *Peat Marwick Ltd. v. Consumers' Gas Co.*, *supra*, footnote 83.

obligation. Quantification of each security interest is not relevant as between the parties to the security agreements. Nevertheless, it would be inconsistent with the underlying legislative policies of both the federal and provincial systems to allow a bank to pick and choose the features of each system most favourable to it. For example, the bank should not be permitted to seize the collateral under the provisions of the Bank Act, yet dispose of it in accordance with a Personal Property Security Act. A bank should be required to elect one system under which it will pursue its remedies. Once there is sufficient evidence of an election to pursue remedies under one system, the right to proceed under the other is foreclosed.⁹⁸ Only in this way can a debtor or a third party whose interest is recognized by the system⁹⁹ know when he can seek relief or compensation for non-compliance with the statutory provisions.

There may well be cases where the court should prohibit a bank from exercising an election of remedies if it concludes that the choice has been induced by a conscious effort to avoid the application of legislative measures of a jurisdiction. For example, under the Saskatchewan Limitation of Civil Rights Act¹⁰⁰ a secured party must go through a special procedure before it is permitted to seize farm equipment. The use of a section 178 security interest along with a Personal Property Security Act security interest may be evidence that a bank is attempting to circumvent provincial law in the event of a default by its debtor. In such a case, a strong argument could be made that Parliament never intended to have section 178 used simply as a device for frustrating valid provincial legislation.¹⁰¹

V. *Complementary Section 178 and Personal Property Security Act Security Interests in Different Collateral*

Nothing in the Bank Act or in a Personal Property Security Act prevents a bank and its customer from entering into a loan agreement under which a security interest is granted to the bank on collateral, some of which falls within the federal system and the balance of which falls under provincial personal property security law. In effect, two security interests securing the same obligation are created either by a single agreement, or by complementary security agreements. Here, too, courts will face difficult conceptual questions when the inevitable clash between the federal and provincial systems occurs.

⁹⁸ *Ibid.*

⁹⁹ See, e.g., S.P.P.S.A., ss. 59(4)(b)-(c), 59(5)(b)-(c), 60, 61(1)(b)-(c), 62(1)(a), 63(e).

¹⁰⁰ R.S.S. 1978, c. L-16, ss. 19-36.

¹⁰¹ The Saskatchewan courts have generally recognized the public policy basis of The Limitation of Civil Rights Act, R.S.S. 1978, c. L-16, and have refused to interpret its provisions restrictively. See, e.g., *Relland Motors Limited v. Foy* (1959), 29 W.W.R. 407 (Sask. C.A.); *Wunder v. Pabereznek*, [1938] 3 W.W.R. 733 (Sask. C.A.).

The two systems will collide in cases where provincial law provides for cancellation of the obligation secured. There is some authority supporting the view that a secured party's non-compliance with certain procedural requirements of the Ontario Personal Property Security Act will bar its right to recover the balance of the debt.¹⁰² In other jurisdictions, seizure of collateral,¹⁰³ or non-compliance with other provincial laws,¹⁰⁴ results in cancellation of the debt. A bank that holds both a section 178 security interest and a Personal Property Security Act security interest may find that it has taken steps which result in discharge of the debt under provincial law. It does not, however, follow that the obligation is extinguished under the federal system.¹⁰⁵

The approach suggested in respect of co-extensive federal and provincial security interests in the same collateral¹⁰⁶ cannot apply where the two security interests do not overlap. Nor does the principle of election apply, since the enforcement of one of the security interests does not necessarily preclude the enforcement of the other.¹⁰⁷ Each security interest is taken on different collateral, and each functions in its own sphere and under its own legal regime.

Although the provinces have constitutional jurisdiction to legislate in the area of personal property security law, the rule of federal paramountcy will render such legislation inoperative to the extent that it conflicts with federal law. In the decision of *Attorney-General for Alberta and Winstanley v. Atlas Lumber Co.*,¹⁰⁸ the Supreme Court of Canada held that provincial legislation which restricted a creditor's right to bring action on a debt could not supersede his right as a holder of a promissory note. If a similar approach is applied to personal property security law, a bank's federal

¹⁰² *George O. Hill Supply Ltd. v. Little Norway Ski Resorts Ltd.* (1980), 1 P.P.S.A.C. 190 (Ont. Dist. Ct.); *Ford Motor Credit Co. of Canada Ltd. v. Preuschoff* (1983), 2 P.P.S.A.C. 279 (Ont. Co. Ct.). Compare *Canada Permanent Trust Co. v. Thomas*, [1983] 6 W.W.R. 130 (Sask. Q.B.).

¹⁰³ See, e.g., *Chattel Mortgage Act*, R.S.B.C. 1979, c. 48, ss. 23-25; *Sale of Goods on Condition Act*, R.S.B.C. 1979, c. 373, ss. 19-20, 22. Under both Acts only a corporation can waive the protection of the seizure or sue provisions.

¹⁰⁴ See, e.g., *The Limitation of Civil Rights Act*, R.S.S. 1978, c. L-16, s. 27.

¹⁰⁵ Similar conduct does not have the same result under section 178. See *Murchison and Murchison v. Bank of Nova Scotia* (1959), 19 D.L.R. (2d) 93 (N.B. App. Div.); *Canadian Imperial Bank of Commerce v. Whitman* (1984), 12 D.L.R. (4th) 326 (N.S. App. Div.).

¹⁰⁶ See text accompanying footnotes 79-101.

¹⁰⁷ See *United Australia, Ltd. v. Barclays Bank, Ltd.*, *supra*, footnote 82, at p. 30; *Findlay v. Findlay*, *supra*, footnote 82, at pp. 778-779.

¹⁰⁸ [1941] 1 D.L.R. 625 (S.C.C.). See also *Duplain v. Cameron* (1961), 30 D.L.R. (2d) 348 (S.C.C.).

rights under section 178 would not be affected by provincial law.¹⁰⁹ Accordingly, even though the obligation secured by both the section 178 security interest and the Personal Property Security Act security interest is discharged or is unenforceable under provincial law, it remains very much in existence for the purposes of section 178.

It has for many years been a common practice for banks to include a proceeds clause in a section 178 security agreement, or in the loan agreement accompanying a section 178 security agreement. Such a proceeds clause is designed to give to a bank a security interest in property received as consideration by the debtor upon a sale of the original collateral to a third party. These clauses usually provide that any proceeds from the sale of collateral described in the security agreement are assigned to the bank and, until actually transferred, are held by the debtor in trust for the bank. If the proceeds property falls within the description of the original collateral contained in the section 178 security agreement no question arises; the proceeds are viewed as original collateral falling under the after-acquired property clause in the security agreement.¹¹⁰ Even if the proceeds property does not fall within the original collateral description, it may still be governed by the federal system if it is of a kind falling within section 178(1). However, if the proceeds property either falls outside the original collateral or proceeds collateral description, or is not of a kind in which a section 178 interest can be taken, the section 178 security interest will not extend to the proceeds. If the bank has a security interest in this property, it must be a security interest governed by provincial law.¹¹¹

It has been suggested that a section 178 security interest extends to all forms of proceeds, even though a bank could not take a section 178 security interest in such property as original collateral.¹¹² This view is based, in part, on a literal interpretation of sections 178 and 186 of the Bank Act. Under these provisions, a bank is treated as having the same rights and powers as if the bank had acquired a warehouse receipt or bill of lading in which the collateral was described.¹¹³ It is argued that the bank must therefore be regarded as the owner of the collateral. When the

¹⁰⁹ See *Landry Pulpwood Company, Ltd. v. La Banque Canadienne Nationale*, *supra*, footnote 6; *Rogerson Lumber Co. Ltd. v. Four Seasons Chalet Ltd.*, *supra*, footnote 8, per Arnup J.A. at p. 677.

¹¹⁰ *Re DeVries et al. and Royal Bank of Canada* (1976), 66 D.L.R. (3d) 618 (Ont. C.A.), affirming in part (1975), 58 D.L.R. (3d) 43 (Ont. H.C.).

¹¹¹ See Macdonald, *loc. cit.*, footnote 1, at p. 1033; Macdonald and Simmonds, *op. cit.*, footnote 1, pp. 306-309.

¹¹² See Heal, *op. cit.*, footnote 1, p. 232.

¹¹³ Section 186 of the Bank Act provides that acquisition of a warehouse receipt or bill of lading acquired by a bank as security vests in the bank "all the right and title to the . . . goods, wares and merchandise covered thereby of the previous holder or owner".

debtor sells the collateral he is selling the bank's property, and any proceeds received from the sale belong to the bank.¹¹⁴

This conclusion is not well-founded. It ignores the other provisions of the Bank Act¹¹⁵ and much of the case law dealing with the nature of the Bank Act device. There is a long line of authorities which establish that a bank holding a section 178 security interest is not an absolute owner of the collateral covered by it, but is the holder of a security interest in the nature of a mortgage.¹¹⁶ When the collateral is sold by the debtor, it is sold subject to the bank's security interest if the sale is not authorized by the bank,¹¹⁷ and is sold free of the bank's security interest if the sale is authorized.¹¹⁸ Where the security agreement expressly or impliedly authorizes the sale and provides that the debtor is to hold the proceeds in trust for the bank, then under the law of trusts the bank will possess a beneficial interest in those proceeds. This interest in the proceeds arises under provincial law, and not under section 178 of the Bank Act.¹¹⁹ The argument that a bank holding a section 178 security interest in original collateral also has a section 178 security interest in the proceeds of the sale of such original collateral is deficient in another respect. Even if it is accepted that a bank has ownership rights in the original collateral, it does not follow that it has any federal rights in the proceeds. Any property right that a bank can have in the proceeds must arise under provincial law and not federal law.

¹¹⁴ See, e.g., *Re Canadian Western Millwork Ltd.'s Bankruptcy, Flintoft v. Royal Bank (No. 2)* (1963), 47 W.W.R. 65 (Man. C.A.) in which Miller C.J.M. stated at p. 73: "I am in accord with the bank's contention that the bank became in effect the owner of the goods by virtue of the security taken under sec. 88 of the *Bank Act* This means that, under the facts herein, the bank would be entitled to receive the proceeds of any sale made by the bankrupt." See also; *Canadian Imperial Bank of Commerce v. R.* (1985), 52 C.B.R. (N.S.) 145 (Fed. Ct. T.D.).

¹¹⁵ Sections 178 and 179 make frequent reference to the bank as having "security". See also, section 180(1). Further, the rights of the bank upon default by the customer are not those of an owner but those of a mortgagee. See ss. 179(4)-(6).

¹¹⁶ See Macdonald, *loc. cit.*, footnote 1, at p. 1023; Baxter, *op. cit.*, footnote 1, p. 211; *Bank of Montreal v. Guaranty Silk Dyeing & Finishing Co.*, *supra*, footnote 31, per Masten J.A. at p. 503; *Royal Bank of Canada v. Workmen's Compensation Board of Nova Scotia*, *supra*, footnote 19, per Davis J. at pp. 566-567; *Canadian Imperial Bank of Commerce v. Gulf Transport Ltd.* (1971), 19 D.L.R. (3d) 104 (P.E.I. C.A.), per Trainor C.J.P.E.I. at p. 110.

¹¹⁷ *Toronto-Dominion Bank v. Dearborn Motors Ltd.* (1968), 69 D.L.R. (2d) 123 (B.C.S.C.).

¹¹⁸ *Bank of Montreal v. J & L Meats Co. Ltd.* (1982), 34 B.C.L.R. 248 (B.C.S.C.); *Hurley and Toronto-Dominion Bank v. Bank of Nova Scotia* (1965), 54 D.L.R. (2d) 1 (S.C.C.); *Indian Head Trading Company Limited v. Royal Bank of Canada*, [1976] 5 W.W.R. 583 (B.C.C.A.); *Port Royal Pulp & Paper Co. Ltd. v. Royal Bank of Canada*, [1941] 4 D.L.R. 1 (P.C.).

¹¹⁹ *Supra*, footnote 111.

The Supreme Court of Canada decision in *Flintoft v. The Royal Bank of Canada*¹²⁰ is said to establish that the bank is the owner of the original collateral, and that it therefore has section 178 “ownership” of the proceeds.¹²¹ However, a close examination of this decision reveals little support for the view that a bank can have a section 178 security interest in proceeds property of a type that could not be taken as original collateral. The issue before the court in *Flintoft* was whether the trustee in bankruptcy of the bank’s customer could have an assignment of book debts granted to the bank declared void for non-registration under the Manitoba Assignment of Book Debts Act. Judson J., who gave the judgment of the court, stated:¹²²

To me the fallacy [in the trustee’s position] 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 those book debts if it is the assignee of them.

His Lordship went on to explain the position of the trustee in bankruptcy:¹²³

He [the trustee] takes the property of the bankrupt subject to the express trust created by the agreement . . . which, in my opinion, cannot be characterized as an assignment of book debts in another form. When these debts, the proceeds of the sale of the section 88 security, come into existence they are subject to the agreement between the bank and customer.

The customer agreed to hold the proceeds in trust, thus the bank’s interest did not depend upon an assignment of the debts. Judson J. concluded that “[a]s between these two the customer had nothing to assign to the bank”.¹²⁴

In support of his conclusion, Judson J. relied upon three decisions that dealt with earlier versions of the Bank Act. He noted that in one of them, the security agreement contained a trust proceeds clause.¹²⁵ In another,¹²⁶ although there was no evidence of an express trust proceeds clause in the agreement, His Lordship concluded that “it is clear that the oral understanding between bank and customer was to the same effect”.¹²⁷ The third case involved a contest between a bank holding a warehouse receipt on wheat and the administrator of the deceased customer’s estate.¹²⁸ The wheat had been converted to flour and sold. There was no evidence of an express trust proceeds clause, or an oral understanding to that

¹²⁰ [1964] S.C.R. 631. There can be no doubt that some of the dicta of Judson J. supports the position taken by the Manitoba Court of Appeal in its characterization of a section 88 Bank Act interest as being “ownership”.

¹²¹ See Heal, *op. cit.*, footnote 1, p. 232.

¹²² *Supra*, footnote 120, at p. 634.

¹²³ *Ibid.*, at pp. 634-635.

¹²⁴ *Ibid.*, at p. 635.

¹²⁵ *Banque Canadienne Nationale v. Lefavre*, [1951] Que. K.B. 83 (Que. C.A.).

¹²⁶ *Union Bank of Halifax v. Spinney* (1906), 38 S.C.R. 187.

¹²⁷ *Supra*, footnote 120, at p. 635.

¹²⁸ *Re Goodfallow, Traders’ Bank v. Goodfallow* (1890), 19 O.R. 299 (Ont. Ch. D.).

effect. The court held that, as against the administrator, the bank was entitled to the proceeds of the sale. Commenting on this judgment, Judson J. observed that "[a]lthough the bank's customer does not sell as agent for the bank, he does not sell free of the bank's claim to the proceeds".¹²⁹ As authority for this proposition he cites Underhill's Law of Trusts and Trustees, where the authors discuss the established rule of trust law that where a fiduciary disposes of property entrusted to him for sale and identified proceeds are received, the entrustor, and not the fiduciary's creditors in bankruptcy, is entitled to the proceeds of the property.¹³⁰

In all three cases the bank's claim to proceeds was founded on the provincial law of trusts and not on the theory that the bank's federal security interest extended to the proceeds.¹³¹ Trust law was invoked either because there was a contractual agreement, express or implied, to hold the proceeds in trust for the bank, or because of a fiduciary obligation¹³² arising by implication of law which gave the bank a beneficial interest in the proceeds.

The conclusion that any general right to proceeds of section 178 collateral must be found in provincial law is supported indirectly by the Bank Act itself. The only mention of a federal right to proceeds is contained in section 179(7), which provides that the bank's security interest extends to goods manufactured or produced from the original collateral.

¹²⁹ *Supra*, footnote 120, at p. 636.

¹³⁰ C.M. White and M.M. Wells, *Underhill's Law Relating to Trusts and Trustees* (11th ed., 1959), p. 562.

¹³¹ This interpretation of the *Flintoft* decision was later taken by the Manitoba Court of Appeal in *Ford Tractor & Equipment Sales Company of Canada Ltd. v. Trustee of Estate of Otto Grundman Implements Ltd.* (1970), 72 W.W.R. 1, per Freedman J.A. at p. 6, who stated:

I perceive no essential difference in principle between the provision in the above case [*Flintoft*] and the one in the agreement here [a wholesale conditional sales contract with a trust proceeds clause]. In both cases there was an express agreement . . . that the proceeds of the sale of the goods which were the subject of the transaction would be held in trust and not owned outright. The provision was held to be valid there and should similarly be held valid here.

See also, D. Waters, *Trusts in the Setting of Business, Commerce and Bankruptcy* (1983), 21 Alta. L. Rev. 395, at pp. 416-424.

Judson J.'s observations concerning the priority position of the bank relating to an assignment of the book debts to an innocent purchaser for value (*supra*, footnote 120, at p. 635) is consistent only with conclusion that the customer held the proceeds interest in trust. If the bank's interest in the accounts was a section 178 statutory security interest, an innocent purchaser for value would take subject to it.

In *Thomas v. Royal Bank of Canada* (1985), 41 Sask. R. 144 (Sask. Q.B.), at p. 146, Halvorson J. held that where there was no proceeds clause in a section 178 security agreement in which crops were taken as collateral, "the interest of the bank in the crops would extend to the insurance money payable in respect thereto However, that result is a consequence of the common law or contractual relations rather than any extension of s. 178(1)(c)".

If Parliament had intended a section 178 security interest to extend to other types of proceeds, section 179(7) would have to be drawn with a wider scope than it was. A security agreement that creates a section 178 security interest together with an interest in proceeds should be viewed as invoking the Bank Act with respect to the kinds of property in which a section 178 security interest can be taken and provincial law with respect to any other property, including proceeds of original collateral, except to the limited extent that section 179(7) permits a federal right to proceeds.

Proceeds clauses in security agreements are designed to create a trust relationship between the debtor and the secured party.¹³³ The reason for their widespread use has been the failure of federal and provincial law to give general recognition to the extension of security interests to proceeds. The need to invoke the law of trusts for this purpose has been eliminated in jurisdictions which have enacted Personal Property Security Acts. This legislation provides an integrated system for the recognition of security interests in proceeds. A Personal Property Security Act displaces trust law with the result that, in jurisdictions which have adopted such legislation, a trust proceeds clause should be viewed as merely an expression of the parties' intention to give to the secured party a security interest in proceeds.¹³⁴ A Personal Property Security Act applies to any agreement that in substance creates an interest in personal property to secure payment or performance of an obligation.¹³⁵ A trust proceeds clause in a section 178 security agreement or in a Personal Property Security Act security agreement is designed to invoke the law of trusts in order to give the secured party an interest in proceeds so as to secure payment or performance of an obligation. It follows that the interest created by such a clause is a security interest governed by the Personal Property Security Act, and as such it will not generally be entitled to priority over other

¹³² In *Henfrey v. G.H. Singh & Sons Trucking Ltd.*, [1982] 2 W.W.R. 177 (B.C.S.C.), at p. 183. Sheppard L.J.S.C. stated: "It seems to me that the best analysis of the relationship between the bank and the debtor is that the debtor is, if not a trustee of its assets covered by the security in favour of the bank, at least in a fiduciary relationship to the bank with respect to those assets."

¹³³ See generally, Waters, *loc. cit.*, footnote 131, at p. 419; J. Ziegel, *The Legal Problems of Wholesale Financing of Durable Goods in Canada* (1963), 41 *Can. Bar Rev.* 54, at pp. 68-69.

¹³⁴ See generally, W. Goodhart and G. Jones, *The Infiltration of Equitable Doctrine into English Commercial Law* (1980), 43 *Mod. L. Rev.* 489.

¹³⁵ O.P.P.S.A., s. 2(a); S.P.P.S.A., s. 3. Waters, *loc. cit.*, footnote 131, at p. 427 stated: "If the courts instead are to hold that such a trust is subject to the legislation, they will have to be prepared to ignore what the parties to an agreement have formally intended, and instead be concerned with the substance of what the parties have done." This is what a Personal Property Security Act requires them to do.

claimants unless it is perfected in accordance with a Personal Property Security Act.¹³⁶

The security interest created by a trust proceeds clause contained in a section 178 security agreement, however, is not a security interest in "proceeds". Under a Personal Property Security Act the term "proceeds" only refers to personal property derived from dealing with collateral subject to a Personal Property Security Act security interest. Since a section 178 security interest is not a "security interest" within the meaning of a Personal Property Security Act, a trust proceeds clause in a section 178 security agreement will give the bank a Personal Property Security Act security interest in non-proceeds collateral rather than in proceeds collateral. For registration purposes such property must be treated as original collateral, and not as "proceeds".¹³⁷

If, as is suggested in the *Flintoft* case, a bank's claim to proceeds can be founded upon a fiduciary duty on the part of the customer to hold the proceeds in trust for the bank,¹³⁸ rather than upon a contractual agreement to hold the proceeds in trust, the bank will not need to rely upon a trust proceeds clause; the bank's interest in proceeds arises not out of an agreement but by operation of law. Where disposition of the original collateral is unauthorized, common law and equity provide remedies through which the bank can assert its interest in the proceeds in the hands

¹³⁶ See *Re McKeown (Horseman's Haven)*, [1984] 6 W.W.R. 274 (Sask. Q.B.) in which The Personal Property Security Act was invoked to determine the priority status of a proceeds clause contained in a loan agreement accompanying a section 178 security agreement.

¹³⁷ It follows from this that a bank claiming a security interest in accounts as proceeds of its section 178 security interest cannot take advantage of those provisions of a Personal Property Security Act which give priority to a purchase-money security interest in accounts over general security interest in the accounts which was registered first; see, e.g., O.P.P.S.A., s. 34(3). Further, an assignment of insurance proceeds payable upon destruction or damage to the original section 178 collateral would not be governed by a P.P.S.A. since the legislation applies only to insurance proceeds payable as compensation for loss or damages to collateral subject to a P.P.S.A. security interest; see S.P.P.S.A., ss. 2(ee), 4(b). However, see *Re Perepeluk; Canadian Imperial Bank of Commerce v. Touche Ross Limited* (1986), 25 D.L.R. (4th) 73, [1986] 2 W.W.R. 631 (Sask. C.A.), in which this point was overlooked.

¹³⁸ Judson J. stated at p. 636: "[T]he 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. Although the bank's customer does not sell as agent for the bank, he does not sell free from the bank's claim to the proceeds There has never been any doubt of the right of the owner to trace the money or any other form of property into which the money has been converted." However, see *Borg-Warner Acceptance Canada Ltd. Ltée. v. Mercantile Bank*, *supra*, footnote 45, in which two judges of the British Columbia Court of Appeal interpreted *Flintoft* as grounding the right to proceeds on the existence of a trust proceeds clause in the section 88 security agreement.

of the debtor and, in some cases, in the hands of third parties.¹³⁹ Where disposition of the original collateral is authorized, a legal obligation to account for proceeds exists at common law and equity when there is a relationship between the parties out of which a fiduciary obligation arises.¹⁴⁰ Judson J. suggested in his examination of *Re Goodfallow*¹⁴¹ that such a relationship exists between a bank holding Bank Act security interest and its customer. If the fiduciary obligation to account arises automatically under provincial trust law and is not dependent upon a trust proceeds clause, a bank's claim to proceeds is not subordinated to a trustee in bankruptcy for lack of perfection under a Personal Property Security Act. Only interests in property arising out of security agreements are subject to a Personal Property Security Act; rights arising by operation of law are not. However, while the bank's interest in proceeds is not subject to subordination at the hands of a trustee, it can be defeated by a person holding a subsequently acquired security interest in the proceeds or a legal title under a subsequent sale where the interest is acquired for value without notice of the bank's beneficial interest in the proceeds.¹⁴²

A bank asserting an interest in proceeds by virtue of a fiduciary relationship between it and its customer will generally prevail over a prior Personal Property Security Act security interest in the proceeds as original collateral. The Personal Property Security Act security interest attaches only when the customer obtains rights in the collateral. If the proceeds are held by the customer as fiduciary and not as owner, there will be no

¹³⁹ See *Canadian Imperial Bank of Commerce v. Kernel Farms Ltd.* (1983), 38 O.R. 614 (Ont. H.C.); and see generally, R.M. Goode, *The Right to Trace and Its Impact in Commercial Transactions* (1976), 92 Law Q. Rev. 360 and 528.

¹⁴⁰ See *Re Hallett's Estate* (1879), 13 Ch. D. 696 (C.A.), per Jessel M.R. at pp. 708-711; *Borden (U.K.) Ltd. v. Scottish Timber Products Ltd.*, [1979] 3 All E.R. 961 (C.A.).

¹⁴¹ *Supra*, footnote 128, discussed by Judson J. in *Flintoft*, *supra*, footnote 120, at p. 636. His Lordship drew a direct parallel between a bank and its customer on the one hand and a consignor and a factor on the other. However, since a factor is an agent, the necessary fiduciary obligation exists.

¹⁴² See *Union Bank v. Spinney* (1907), 38 S.C.R. 187, at p. 195. See generally, D.W. Waters, *Law of Trusts in Canada* (2nd ed., 1984), p. 1043. In the *Flintoft* case, Judson J. observed that an assignment of the book debts by the bank's customer "to a third party would fail unless the third party was an innocent purchaser for value without notice"; *supra*, footnote 120, at p. 635. It has been held that a Notice of Intention registered under section 178(4) is constructive notice of the bank's interest in the original collateral and proceeds. See *Henfrey v. G.H. Singh & Sons Trucking Ltd.*, *supra*, footnote 132. Accordingly, no purchaser of the proceeds could be without notice if a Notice of Intention is registered by the bank claiming the proceeds. It is very difficult to see how this can be so. The interest in proceeds is a provincial interest. Surely Parliament could not be seen as intending registration under section 178(4) as affecting dealings with provincial interests.

attachment.¹⁴³ However, if the bank's security interest in the original collateral is subordinate to a prior Personal Property Security Act security interest in the same collateral, the bank's claim to proceeds of the original collateral will be subordinate as well.

One might well question whether it is appropriate to view the relationship between the bank and its customer as a fiduciary relationship. In *Re Goodfallow* the court adopted the now largely discredited view that a bank which obtains warehouse receipts under the Bank Act becomes the owner of the property covered by the receipts such that the bank also owns the proceeds from the sale of such property. Perhaps it is time to reject outright the suggestion that the mere grant of a section 178 security interest to a bank imposes on the customer a fiduciary obligation to hold proceeds of an authorized disposition of section 178 collateral in trust, and to recognize that the bank's claim to proceeds is founded on a contractual agreement between the bank and its customer. A fiduciary obligation to hold proceeds in trust for the bank should be imposed only where the debtor has made an unauthorized disposition of the collateral, thus placing the bank in a position identical to that occupied by a mortgagee under provincial common law.¹⁴⁴

Conclusion

The personal property security law of four Canadian jurisdictions has gone through a revolutionary change in recent years. There is every reason to think that in the near future a majority of Canadian jurisdictions will have enacted a Personal Property Security Act. Federal personal property security law has been recently amended as well, but on a far more modest scale. A new era has begun, an era in which a fresh approach to the relationship between federal and provincial personal property security law is required. New concepts such as purchase-money security interests and security interests in proceeds, and new practices such as registration of section 178 security interests in Personal Property Security Act registries and the use of overlapping section 178 and Personal Property Security Act agreements have created legal problems not encountered in the past.

In this article, the authors have gone beyond mere description of these problems. They have proposed legal solutions which are grounded on the essential features of the section 178 and Personal Property Security

¹⁴³ See *Royal Bank of Canada v. General Motors Acceptance Corp. of Canada*, *supra*, footnote 45. In *Borg-Warner Acceptance Canada Ltd./Ltée. v. Mercantile Bank of Canada*, *supra*, footnote 45, a trust proceeds clause was found to be the basis for the priority given to the holder of a security interest in the original collateral.

¹⁴⁴ See Goode, *loc. cit.*, footnote 139.

Act systems and on basic principles of property law. However, it would be a mistake to assume that these solutions are an acceptable basis for long term development of this area of the law. It is clear to the authors that ultimately legislative solutions will be required, and that anything short of a restructuring of the section 178 Bank Act system along the lines of provincial Personal Property Security Acts will very likely be inadequate.