MISTAKE, SHARP PRACTICE, EQUITY 
AND THE PPSA

John J. Chapman*
Toronto

Personal property security legislation in force in most provinces is designed to create certain priority rules in the belief that this certainty will enhance the efficiency of the credit market to the benefit of the economy as a whole. Not unexpectedly, litigants who are disappointed in the apparent application of the statutory priority rules have sought to supplement, if not reverse, such rules by invoking a variety of fairness driven doctrines. Although the case law is still mixed, more recent decisions have exhibited a strong view that the court should not allow equitable concepts to alter statutory priorities. In the author's view this approach is wise. To give scope to the application of equitable concepts would be to require the courts to balance a whole series of costs to the credit market against the possible benefits of enhanced judicial discretion. In the author's view it is questionable whether the court has the statutory mandate or the institutional competence to engage in this task.

La législation sur les sûretés réelles mobilières, en vigueur dans la plupart des provinces, établit des règles de priorité certaines et repose sur la croyance que cette certitude augmentera l'efficacité du marché du crédit, pour le bénéfice de l'économie en général. Il n'y a rien d'étonnant à ce que certains plaideurs, déçus de l'application des règles légales de priorité, aient tenté de les compléter, voire de les écarter en invoquant diverses doctrines inspirées de l'équité. Bien que la jurisprudence soit encore partagée, il se dégage des décisions plus récentes une forte opinion que les tribunaux ne devraient pas se permettre de modifier les priorités légales en ayant recours à des concepts d'équité. L'auteure est d'avis qu'il s'agit là d'une sage vision des choses. Permettre un tel élargissement des concepts d'équité exigerait des tribunaux qu'ils pèsent les avantages résultant possiblement d'une plus grande discrétion judiciaire, d'un côté, et de toute une série de coûts pour le marché du crédit, de l'autre côté. L'auteur doute que les tribunaux aient reçu un tel mandat du législateur et qu'ils possèdent la compétence institutionnelle pour ce faire.

I. Introduction .......................................................................................72
II. The Relevant PPSA Provisions .........................................................72
III. The Possible Costs and Benefits ....................................................76
   (ii) The Difficulty in Drawing Lines: Royal Bank v. Sparrow Electric .................79
   (iii) The Price of Uncertainty ..........................................................81
   (iv) The Benefits of Judicial Discretion .........................................83
   (v) Summary ...................................................................................84

IV. **Competing Equitable Doctrines** .......................................................... 84
   A. **Unjust Enrichment** ......................................................................... 86
      (i) **Registration Errors** .................................................................. 88
      (ii) **Equitable Subrogation** .............................................................. 94
      (iii) **Knowing Receipt by Secured Creditors**
           of Trust Property ........................................................................... 95
      (iv) **Involuntary Creditors/Debtor Misconduct** .............................. 98
   B. **Equitable Subordination** ................................................................. 102
   C. **The Oppression Remedy** ................................................................. 106
V. **Summary** ............................................................................................ 110

"Better to leave an occasional widow penniless by the harsh application of the law than to disrupt thousands of other transactions by injecting uncertainty and by encouraging swarms of potential litigants and their lawyers to challenge what would otherwise be clear and fair rules ... The important strength of Article 9 has been the rigidity and accompanying certainty of its priority rules. Saved costs that would otherwise be spent in negotiation and preparation of deals and in contention in litigation after the fact should not be underestimated. The courts should not believe that they serve society by taking in pitiful strays such as good faith, estoppel, and the equitable lien ..."\(^1\)

I. **Introduction**

The situation is a familiar one. An insolvency has occurred. A creditor is reviewing its security position. It is not as it thought it was. A registration may not have been made. A registration may have contained an error. A registration may have lapsed, not been properly amended or been inadvertently discharged. A third party which knew about the creditor’s secured position and which advanced believing it was subsequent in priority may now assert priority. A windfall may result. A creditor may find that a registered security interest is in favour of a party related to the debtor, such as a controlling shareholder or director. There may be a concern that the related party has acquiesced in or triggered an insolvency in the expectation that it will be able to buy the assets from a receiver or trustee at a discount, shed the unsecured or under-secured creditors and start the business afresh. A related party who may be considered by the creditor to be at fault for the insolvency may not suffer while innocent creditors bear all the loss.

The creditor will seek legal advice. The statutory priorities will be considered. The black and white of the applicable statute will often seemingly defeat the creditor’s claim. But the legal advice will not stop at the statute. The

creditor will be advised that there is a possibility that under the doctrines of unjust enrichment, equitable subordination or corporate oppression that the normal statutory priority rules can be upset or that some party other than the primary debtor may be held responsible for the creditor’s loss. It will be difficult in advance to predict the likelihood of the success of such arguments succeeding. Even if the law is receptive to the application of fairness driven concepts, the determination of the merits of such claims will require a meticulous examination\(^2\) of all the dealings between the parties and of all the underlying facts.

The legal principles applicable to such disputes will involve a consideration of the wording of the statute directly applicable to the priority dispute to see whether, and to what extent, equitable doctrines can be used to avoid the occasionally harsh consequences of statutory priority rules. The wording and policy basis for the statute will need to be weighed against the policy basis for each equitable doctrine. This weighing will, in turn, need to be considered against a more general background of how Canadian commercial law in the late 20th century is balancing the interests of certainty and fairness. It will involve a consideration of the proper role of the court in using equitable doctrines to supplement or supersede statutory priority provisions and of the court’s ability, as an institution, to fully weigh the competing policy and commercial considerations that arise from such a process being pursued.

This article will be divided into three parts. Firstly, a summary will be given of the provisions of the Personal Property Security Act (the “PPSA”) which may seem to allow the court to use equitable concepts to relieve against statutory priority rules. The Ontario statute\(^3\) will be the centre of the discussion with occasional reference to other provincial legislation.\(^4\) Secondly, there will be a discussion of considerations which may arise if we seek to give the courts this task. Thirdly, there will be a discussion of possible doctrines which might be employed in an effort to ameliorate the effect of statutory priority rules. The view expressed will be that in the area of secured transactions the courts in general have neither the statutory mandate nor the institutional competence to use equitable concepts to alter statutory priorities.

II. The Relevant PPSA Provisions

Provincial legislation governs the creation, validity and priority of secured interests against the assets of a debtor. These provincial rules are respected on


\(^3\) R.S.O., 1990 c. P-10, as amended.

a bankruptcy by Section 136 of the Bankruptcy and Insolvency Act (the "BIA") which provides that the interests of creditors on bankruptcy are subject to the rights of secured creditors.  

The history leading up to the passage of PPSA legislation, first in Ontario and later in other provinces, has been canvassed so many times that there is no need to repeat it here. Article 9 of the American Uniform Commercial Code was the model from which the PPSA's key concepts came. Its heart was the computerised registration system and the general rule of priority in order of registration. The PPSA jettisoned common law security concepts and rules. Its fundamental aim was to provide rules under which commercial transactions could be concluded with reasonable simplicity and certainty. Arguably, it was highly favourable to secured creditors, both as compared to the previous law and as compared to the position of secured creditors in other jurisdictions. The PPSA was designed, within its scope, to be a comprehensive code and to supplant substantially all existing security devices relating to personal property and fixtures that fell within provincial jurisdiction. "When the Legislature enacted the PPSA, the benefits of certainty were consciously substituted for the benefits of fairness in individual cases". With one exception, the PPSA has priority if there is a conflict between it and other provincial statutes.

Although the PPSA was intended, within its scope, to be a comprehensive code of priorities, it could not pretend to be entirely isolated from the rest of the law. No statute can be an island unto itself. Section 72 provides: "Except insofar as they are inconsistent with the express provisions of the PPSA the principles of law and equity shall continue to supplement the Act and shall

---

5 Re Gifen, [1998] 1 S.C.R. 91. This is of course a simplification given that the provinces do have limits on the extent to which they can, by creating security interests or interests tantamount to security interests, interfere with the scheme of priorities under the BIA. The constitutional decisions in this area may not be fully coherent and the details of the limitation on provincial jurisdiction are not relevant for this article.


8 F. Catzman et al., Personal Property Security Law in Ontario (Toronto: Carswell, 1976) at 2-3.


10 Section 73. The exception relates to conflicts with the Consumer Protection Act, R.S.O. 1990 C.31. The other provincial legislation has similar provisions. If there is a conflict between federal legislation and the PPSA, the federal legislation takes precedence.
continue to apply.”11 The reason for Section 72 is obvious. Common law concepts are clearly necessary to supplement the operation of the Act. For instance, general contract principles apply to questions relating to the creation, application and interpretation of security agreements. Larger and more difficult questions emerge, however, when one tries to see exactly how far one can go in the process of incorporating the rules of the common law or equity. There is room for disagreement over when such doctrines cross the line from supplementing the PPSA, which is permissible, to being inconsistent with express provisions, which is not.

A further possible statutory source for the importation of equitable concepts is to be found in the application provisions of the PPSA. The PPSA does not apply “to a lien given by statute or rule of law” (emphasis added).12 When a PPSA security interest comes into conflict with an interest which fits within this exception priorities are determined according to the common law.13 It may well be that the intent behind the original limitation on the scope of the PPSA was to permit the continued functioning of government liens and other relatively specific non-consensual common law or statutory liens which were not felt to have a large impact on the overall integrity of the PPSA and the commercial credit market it serves. The wording of the exception is such, however, that it may permit a wider application. If a court seeks to impose an “equitable lien”14 as a first charge in order to avoid unjust enrichment, can the court proceed to do so on the basis that such a lien is imposed by “rule of law” and is thus entirely outside the scope of the PPSA? A further complication is raised by the PPSA statutes of many of the provinces which have provisions requiring that secured creditors in exercising rights under the PPSA are to act in “good faith”.15 What content is to be given to the concept of good faith in secured transactions?

11 The comparable sections in other statutes are s. 66(1) (Alta.), s.68 (B.C.), s.65(1) (N.B.), s.66(1) (N.S.) and s.65(2)(Sask.). There is no specific provision in the Manitoba Act. Under s. 72 of the BIA that act shall “not be deemed to abrogate or supersede the substantive law or statute relating to property or civil rights that are not in conflict with the act”. Under s. 183 the bankruptcy court is invested with “such jurisdiction at law or equity as will enable it to exercise original, auxiliary and ancillary jurisdiction in bankruptcy.”

12 Subsection 4(1)(a).There are two exceptions to this provision which are not relevant for the purposes of this article.


14 The term “lien” is not defined in the PPSA. It has had varying definitions ascribed to it over the years. The older use equated it with a right of possession or detention. Latterly, it is often used in the same sense that the word “charge” is used: Deputy Minister of Revenue v. Rainville, [1980] 1 S.C.R. 35 at 51. For a spirited discussion see John Deere Ltd. v. Firdale Farms (Receiver of) (1988), 45 D.L.R. (4th) 641 (Man. C.A.).

15 Section 66(1) (Alta.), s.68(2) (B.C.), s.65(3) (Sask.), s.65(2) (N.B.) and s.66(2) (N.S.).
To state these questions is to make it obvious that serious policy questions arise when one seeks to import equitable concepts into the PPSA. The historic importance of equity in softening the harsh edges of the law cannot be overstated.\textsuperscript{16} The failure to allow for any relief from occasionally harsh statutory results by invoking doctrines inspired by deeply felt notions of individualized fairness may permit conduct which is morally offensive to go unpunished and, indeed, to be rewarded. Conversely, allowing the courts too wide a latitude in permitting such considerations to sway their determination of priorities creates the possibility of increased litigation and the undermining of the aims of the PPSA. In recent years, “there has a marked trend away from strict rules and towards flexibility and importing into the law what can be described as broad moral principles of reasonableness, fair dealing and good conscience”.\textsuperscript{17} Whether the law of secured transactions is to follow contract, fiduciary obligations and corporate law down that path is an issue which is not divorced from the developments in commercial law generally.

III. \textit{The Possible Costs and Benefits}

(i) \textit{The Quality of Judicial Decision Making: 1976-1996}

One question which might be asked in addressing the question of whether, and to what extent, the courts should use flexible, equitable concepts in the area of secured transactions is “How good would they be at it?” If all judges had a full appreciation for the commercial realities of the secured transaction marketplace, of the underlying policy reasons which gave rise to the PPSA, and of the extent to which concepts of fairness might be used without undermining the integrity of the PPSA, we all might be inclined to leave such difficult decisions to their wise judgment. Such hypothetical judges might be expected to draw and apply lines properly. Unfortunately, at least if one accepts the learned academics and practitioners who comment on the court’s performance in this area,\textsuperscript{18} it is by no means clear that the court, as an institution, possesses these characteristics.

When the PPSA statutes were enacted the bench and the bar were faced with a code of priorities which was novel to them. Virtually all of the key concepts in the Act—“security interest”, “attachment”, “perfection”, “PMSI”—were entirely outside their experience. If this task of the assimilation and

\textsuperscript{16} The priority of equity over the common law was specifically provided for in the \textit{English Judicature Act}, 1873 and is found today, for instance, in the \textit{Ontario Courts of Justice Act}, R.S.O. 1990 c.C.43, section 96(2).

\textsuperscript{17} The Hon. R.J. Sharpe, “The Application and Impact of Judicial Discretion in Commercial Litigation” (Unpublished, 1997).

\textsuperscript{18} I am not such an expert. I am more interested in what the criticism as a whole tells us about the court’s performance than I am in the correctness of any particular criticism.
comprehension of entirely new concepts was not daunting enough, the legislation and the wide variety of circumstances where it might come into play gave rise to highly technical and complex issues. In some instances, the PPSA provided limited guidance to the courts as to how the new concepts were to be applied to actual business practices. The continuation of parallel security regimes under the Bank Act and, in Ontario, the Corporation Securities Registration Act compounded the complexity. Even the experts in the area concede that certain of the PPSA rules were “monstrously complicated.” Often the act appeared to lead to unexpected results or to results which, to one trained and brought up under a different system, were counterintuitive.

In an era of change it is not surprising that many early decisions were either in error or reflected a mis-appreciation for the very underpinnings of the PPSA. It might also have reasonably been expected that with time and experience the court system’s track record would improve significantly. Although some troubling decisions were either corrected on appeal or effectively disapproved of in later cases, the court system’s performance in this area as late as the mid-1990s was very uneven at best. The difficulties ran across the entire gamut of the PPSA. There were questionable decisions on what assets might be subject to the PPSA, on what type of transactions amounted to the grant of a security interest, on whether an unperfected PPSA security interest was in fact subordinated to a trustee in bankruptcy, on whether the concept of “actual”

---

19 e.g. J.S. Ziegel, “Canadian Perspectives on How Far Article 9 is Exportable” (1996) 27 Can. Bus. L.J. 226 at 233. (“The original Ontario Act gave no guidance to the courts on how to distinguish between security and non-security leases”).

20 R.S.O. 1980, c.94.


22 e.g., McLaren, supra note 6 at 1-62.1, in referencing the trial decisions in Re Urman and C.T.L. Uniforms Ltd. v. ACIM Industries Ltd. states: “(the) decisions... created a minor panic among real estate practitioners.”

23 J.S. Ziegel, “Recent and Prospective Developments in the Personal Property Security Law Area” (1985) 10 C.B.L.J. 131 at 167 “a distressing large number of decisions are inadequately reasoned and show an incomplete grasp of the principles of the Acts”.


26 Re Giffen (1996), 131 D.L.R. (4th) 453 (B.C.C.A.) which was mercifully reversed on further appeal to the Supreme Court of Canada, at supra note 5.
notice still applied,\textsuperscript{27} a particular inability to jettison the common law concept of the floating charge,\textsuperscript{28} an apparent mis-appreciation of the business realities leading to the need for subordination agreements,\textsuperscript{29} a lack of understanding of the rules relating to priority to proceeds of collateral,\textsuperscript{30} difficulties in the interface of the \textit{PPSA} with the \textit{Bank Act},\textsuperscript{31} and many other errors.\textsuperscript{32} Many of the questionable decisions may have been driven by an erroneous understanding of the operation of the commercial marketplace and of "commercial reality."\textsuperscript{33}

It would be unfair to lay all or even most of the blame for such a spotty performance on the judiciary alone. The bar bears its portion as well. Lawyers tenaciously clung to old common law precedents. Often, the precedents were uncritically assumed to rule. In some cases concessions were made by counsel as to the applicability of the \textit{PPSA} which were difficult to reconcile with the provisions of the \textit{PPSA} itself.\textsuperscript{34} In reliance on such concessions, the courts rendered decisions which were later inadvertently picked up by other judges and

\begin{itemize}
\item \textsuperscript{27} Although the majority of the cases held that the doctrine of actual notice was not relevant, contrary authority existed as late as 1986. The concept of "actual notice" was also relied upon in considering the scope of the curative provisions in the \textit{PPSA} until overruled in \textit{Re Lambert} (1994), 119 D.L.R. (4th) 93, 123 D.L.R. (4th) vii, leave to appeal refused.
\item \textsuperscript{29} K. Morlock, "Floating Charges, Negative Pledges, the \textit{PPSA} and Subordination: \textit{Chips Inc. v. Skyview Hotels Limited}" (1995) 10 B.F.L.R. 405 "Several of the (subordination) cases appear to have been decided on an \textit{ad hoc} basis with lamentably little in the way of stated reasons. A few of the cases appear to be logically inconsistent with each other...".
\item \textsuperscript{30} J.S. Ziegel, "Tracing of Proceeds Under the Ontario Personal Property Security Act" (1988) 13 C.B.L.J. 177, commenting on \textit{General Motors Acceptance Corp. of Canada v. Bank of Nova Scotia} (1986), 55 O.R. (2d) 438 (C.A.) "a highly compressed and seriously incomplete judgment that raises as many questions as it answers ...".
\item \textsuperscript{31} Ziegel, \textit{supra} note 19 at 234 "The lamentable decision of the Ontario Court of Appeal in \textit{Bank of Nova Scotia v. International Harvester Credit Corp. of Canada} (1990), 73 D.L.R. (4th) 385"; B. Crawford, "Interaction Between the \textit{PPSA} and Section 178 of the \textit{Bank Act}" (1993) 8 B.F.L.R. 1 at 15 - 18.
\item \textsuperscript{32} e.g. McLaren, \textit{supra} note 6 at 5-56, criticizing \textit{Toronto Dominion Bank v. Lanzerotto Wholesale Grocers Ltd.} (1996), 12 P.P.S.A.C. (2d) 30 (Ont. C.A.) (dealing with the specificity of \textit{PMSI} notices) as wrongly decided, J.S. Ziegel, "Deficiency Claims and the \textit{OPPSA}: \textit{Royal Bank v. Segreto Construction Ltd.}" (1989) 3 B.F.L.R. 196 at 200 "The first two grounds (of the Court of Appeal decision) are untenable and the third at best equivocal.".
\end{itemize}
compounded the error. It was not unusual for counsel to take a kitchen sink
approach.\textsuperscript{35} The result was often the diversion of judicial talent in the chasing of
flawed red herrings with a consequent failure to appreciate the central issues. Why,
it might be asked, did the judiciary and the bar have such a difficult time in this area
of the law? Much of the explanation must be laid to the difficulty in coping with
change and the natural human inertia which makes lawyers reluctant to cast off
comfortable common law concepts.\textsuperscript{36} The training of lawyers and judges which
engrained in them an obedience to precedent\textsuperscript{37} and taught them that the law evolved
from case to case, was an intellectual trap from which they could not escape when
faced with a new code. The legislation was so novel and the circumstances which
can lead to litigation so variable that the bench and the bar simply did not have, on
average, the same institutional ability to analyse and solve problems related to the
PPSA that they did for commercial claims grounded in the common law. Unable
to rely upon a solid basis of expertise or a reliable foundation of precedent, the
courts bent the statute to achieve perceived fairness.\textsuperscript{38}

In the author’s view, if one accepts the criticism of the court system by the
commentators, one would be very hesitant to give the court any discretion, much
less a wide discretion, to alter statutory priorities using some inherent equitable
power. It has had so much difficulty applying the statute as written that one
might shudder at the implication of vesting in it this additional power. There is
little reliable evidence that the court system as a whole could exercise such a
power in a manner which does not do undue violence to the policy reasons which
gave rise to the PPSA.

(ii) The Difficulty in Drawing Lines: Royal Bank v. Sparrow Electric

Although the experience in the first 20 years of the PPSA was not
encouraging, it would be misleading not to mention some hope which arises out
of Royal Bank v. Sparrow Electric.\textsuperscript{39} Royal Bank v. Sparrow Electric was

\textsuperscript{35} For example, the trial arguments in Re Haasen (1992), 8 O.R. (3d) 489.
\textsuperscript{36} Ziegel, supra note 19 at 231: “Changing the ground rules in so basic a branch of
commercial law as the law of secured transactions involves abandoning a large corpus of
recondite rules and may appear to threaten the livelihood of those who have learned to
master them.”. It may be that some had an intellectual fondness for the old concepts, e.g.,
W. Gough, “The Floating Charge” in Equity and Commercial Relationships” (Finn, ed. The
Law Book Company, 1987) at 239 “The floating charge is...one of equity’s most successful
and far reaching creations”.
“precedents survive in the law long after the use they once served is at an end and the reason
for them has been forgotten”.
\textsuperscript{38} For example, Morlock, supra note 29, at 422-3; B. Crawford, “Interaction Between
the PPSA and Section 178 of the Bank Act” (1993) 8 B.F.L.R. 1 at 10, 11 “… the judges
find it offensive to give Section 179 (of the Bank Act) its plain meaning. ... The result
probably worked a rough equity as (the bank) would have realized a windfall gain.”.
\textsuperscript{39} (1997), 143 D.L.R. (4th) 385 (S.C.C.). Further hope for better decisions may exist
as a result of the Supreme Court of Canada decision in Re Giffen, supra note 5.
another in a sequence of cases relating to the priority to be afforded to the federal deemed trust for withholding taxes. It is of interest on at least two levels. First, all justices of the court were able to agree that the provisions of the PPSA had rendered the common law concept of a floating charge a historical anachronism and that under the PPSA legislation a security interest in present and after-acquired property was a fixed charge which generally attaches at execution of the security agreement. Royal Bank v. Sparrow Electric thus finally disposed of a specific, important issue which had troubled a great many courts for a great many years. It offers some hope that courts can adapt, albeit after approximately 20 years, to the new statutory regime of the PPSA.

Royal Bank v. Sparrow Electric is of even more importance for the tension it shows us in the majority and minority decisions in relation to the competing values of fairness and certainty. The division emerged in relation to the possible application of the license theory to defeat what would otherwise be the bank’s priority under a PPSA security interest over the federal deemed trust for withholding taxes. Gonthier J., for the minority, noted that there were competing policy objectives involved. The PPSA had been designed to increase the certainty and predictability of secured transactions in order to benefit the economy as a whole. The federal deemed trust was designed to protect the fiscal integrity of public institutions. In arriving at his balancing of these values he noted that the effect of the failure to remit withholding tax was to enlarge the working capital available to pay other creditors. The failure to remit by the debtor was a “misappropriation” of the property of another. Gonthier J.’s reasons have as their sub-text the possibility that the bank had been unjustly enriched by debtor conduct which was tantamount to theft. The bank had agreed that the debtor could sell assets subject to the bank’s security and use the proceeds in the ordinary course of business, including the payment of the withholding taxes in issue here. “The bank was willing to accept the benefit of the debtor’s non-payment of statutory deductions but refused to accept the burden.” He concluded that as a result of the license to permit sale of collateral the bank had waived its right to claim priority over the deemed trust. In Mr. Justice Gonthier’s view the license theory had “the virtue of achieving fairness in commercial law” and was “grounded ... in sound policy.”

Iacobucci J. for the majority disagreed. The license theory relied upon by Gonthier J. proved too much. If it was applied in the context of the federal

---

40 This is not to say all commentators are without criticism for the thought process which led to the result, e.g., McLaren, supra note 6 at 2-42.
41 Supra note 39 at 397.
42 At 399. The suggestion is that the misappropriation was effectively stealing from employees. As Davis, “Priority of Crown Claims in Insolvency: Royal Bank of Canada v. Sparrow Electric Corp. and its Aftermath”, (1997) 29 C.B.L.J. 145, points out at footnote 28, this is not strictly correct. The employee does, in fact, receive credit for the amounts the employer failed to remit.
43 At 422.
44 At 422.
45 At 423.
deemed trust, it could also be applied to the benefit of other creditors who had dealt with the debtor. It ran the risk of “eviscerating” PPSA security interests. Iacobucci stated:

...tinkering with security interests is a dangerous business. The risks of judicial innovation in this neighbourhood of the law are considerable.

Chief among these is the risk that attends legal uncertainty. If the legal rule is not clear, then inventory financiers will have to provide against the risk that their security interest might be defeated by some rival claim. The danger is particularly acute where as here, the language is as broad as “in the ordinary course of business”...

...The possibility is real that my colleague’s proposed rule would effectively obliterate the PPSA charge against inventory. As insurance against this outcome, the courts must perforce accept it. However, judges should not rush to embrace such a weighty consequence unless the statutory language requiring them to do so is unequivocal...

The bank had never explicitly agreed that its security would rank behind the federal deemed trust. It was irrational to suggest that the license to sell amounted to some implicit waiver by the bank of priority. Why would any bank in its right mind waive its priority when there was no reason to do so? Mr. Justice Iacobucci’s decision reflects a worldview that there is nothing wrong with a secured creditor bargaining for as high a priority as it can get and enforcing that bargain post-insolvency, whatever perceived unfairness might result.

Royal Bank v. Sparrow Electric is of interest in what it tells us about the judicial process and the extent to which policy considerations often seem to be somewhat in the eye of the beholder. Gonthier J. is a very experienced and able judge with a particular expertise in insolvency matters. Although his reasons suffer from a certain leap in logic given their eventual reliance on a deemed voluntary partial waiver by the bank of priority, his fairness inspired arguments might well be attractive to many. It is possible to say Mr. Justice Iacobucci’s decision is preferable. It is not as easy to say Mr. Justice Gonthier’s decision is wrong. There is at the core a different balancing of two competing and fundamentally incompatible values.

(iii) The Price of Uncertainty

The primary purpose of the PPSA was to permit the efficient functioning of the commercial marketplace with the overall goal of reducing the costs associated with the granting of credit. This, if one accepts a competitive market,

---

46 At 431-2.

47 The majority in Royal Bank v. Sparrow Electric was only formed as a result of McLachlin J. joining Iacobucci J. in his reasons. McLachlin J., while a trial judge, was one of the judicial originators of the license theory relied upon by Gonthier J. and her joining the majority must be taken as a repudiation of her former views. Not only can views of what is fair be the subject of reasonable disagreement between able judges but individual judges can, over time, change their opinion on such issues.
eventually leads to a lower cost of borrowing to borrowers and enhanced economic performance to the benefit of society as a whole.\footnote{The entire court accepted this in Royal Bank v. Sparrow Electric, supra note 39 and in Bank of Montreal v. Hall, [1990] 1 S.C.R. 121.} A broad policy question which emerges is what adverse impact, if any, the introduction of equitable concepts would have on this purpose.

A number of costs can be identified. They are less easy to quantify with anything approaching precision. First are the costs associated with the conduct of litigation. These costs are not to be underestimated. In the modern world the photocopier, word processor, fax machine and the 19th century rule that all documents with a semblance of relevancy must be produced in litigation results in boxes upon boxes of documentary productions in everyday commercial actions. In complex actions examinations for discovery frequently take weeks. The costs are enormous. The delays are notorious. The soft costs are significant. Senior personnel of parties may need to devote a substantial portion of their time, stretching out over many months or years, to the litigation process. All of the effort devoted to loss allocation diverts the efforts of many from wealth creation. One can only speculate as to the number of additional legal cases that might be spawned. However, in an age where we are told that one party’s costs of a simple action involving a three day trial are normally in the range of $38,000\footnote{Civil Justice Review. (Toronto, Queen’s Printer. 1995) at 144.} and where we are told that one complex case involving the application of fairness considerations to creditor claims on an insolvency took seven and a half years and over $5,000,000 in legal costs to litigate\footnote{B. Crawford & C. Campbell, “The Use of Participation Agreements in Bank Rescues: Bovill’s Act and Equitable Subordination in Hybrid Investments" (1994) 9 B.F.L.R. 45 at 58, commenting on Canada Deposit Insurance Corp. v. Canadian Commercial Bank, [1992] 3 S.C.R. 558. The authors indicate that the costs incurred exceeded the amount involved.}, there is no doubt that there is a real potential for significant costs to be added to the system as a whole.

Further, there is a risk that if additional uncertainty is injected into the system lenders will ask for additional financial compensation for their uncertainty or will reduce the level of debt they would otherwise be prepared to advance or both. When faced with a deteriorating credit they may be more inclined to impose restrictions on credit or take early realization steps. Lastly, the introduction of uncertainty may have an adverse impact on the ability to successfully reorganize under the BIA or CCAA.\footnote{Companies’ Creditors Arrangement Act, R.S.C. 1985 c.C-36, as amended.} A debtor has only a very restricted period of time within which it can propose and negotiate with creditors over alterations to the debtor’s obligations. The differing interests of stakeholders make such negotiations highly complex. Uncertainty as to what legal positions stakeholders truly have can only lead to greater difficulty in achieving a successful reorganization. There is usually no time in such reorganization for trials to determine whether a fairness inspired doctrine should be used to alter statutory provisions. All parties of necessity must be
taken to have the black and white priority the statute affords them for the purpose of creditor and class classification and voting. To the extent possible, all parties must be able to make their decisions with a firm understanding of what their security position is.52

(iv) The Benefits of Judicial Discretion

Arrayed against these costs are the possible benefits of widened judicial discretion. First, it must be noted that the lending environment in Canada is highly favourable to secured creditors. Some judicial discretion to relieve against perceived unfairness may still leave Canadian secured creditors in a preferred position as compared to secured creditors in many other industrialized jurisdictions. Secondly, one can point to a generalized trend, particularly in the context of restructurings, to limit the normal absolute rights of secured creditors by use of the stay powers in the BIA and CCAA. Courts have clearly been sensitive to the interests of other stakeholders and have acted to curb possibly precipitate conduct by secured creditors. They have become increasingly managerial. Although these powers have been exercised in an environment of negotiation which requires secured creditors at the end of the day to consent to an alteration of their rights, there is little doubt that these developments reflect a judicial awareness that the rights of secured creditors are not as absolute as they may once have been. The liberal use of the stay power often has a disproportionate effect on secured creditors whose security may be eroding over the stay period. As a practical matter the stay power often acts as a coercive mechanism by which secured lenders are encouraged to compromise their rights. Orders permitting debtor in possession financing in priority to that of secured creditors and judicial dicta suggesting that the doctrine of substantive consolidation may be available under the CCAA53 suggest that the court may reserve unto itself, in the context of the wide discretions contained in the CCAA, the power to effectively alter the rights of secured creditors. The eventual approval of a CCAA plan must meet the test of "fairness and reasonableness", a flexible test if ever there was one. The courts have reflected and will continue to be influenced by societal views as to the proper balancing of rights on insolvencies.54

52 I realize, of course, that much after the fact litigation occurs, most usually with respect to preferences, conveyances or settlements. Nevertheless, adding another layer of complexity to the decision making process is not to be encouraged.
Although these developments have largely been in the area of reorganizations where the focus is on preservation and enhancement of existing value, there is no doubt that experience with these proceedings has some influence on judges and lawyers dealing with priority disputes in insolvencies.

(v) Summary

Concerns about the court’s institutional competence, the difficulty of making value choices in this area and the resultant costs and uncertainty injected into the commercial credit system, all suggest to the author that the court should be extremely reluctant to venture outside of the black letter rules in the PPSA unless the specific statutory wording tells them to do so. Widening judicial discretion in this area may cause as much injustice as it cures. In the author’s view, at the least the courts should be cautious about assuming, under the mantle of equitable discretion, a task which may more properly be a function of legislative law reform. This consideration is particularly compelling given the frequency that the law in this area has been the subject of comment by recommendatory bodies and of legislative revision.

IV. Competing Equitable Doctrines

Before engaging in a discussion of particular equitable doctrines it is worthwhile to briefly discuss some general rules of statutory interpretation. A perpetually difficult question is whether and to what extent a statute supplants common law and equity. In the leading case in the Supreme Court involving registration statutes we are told by the majority that “a cardinal principle of property law cannot be considered to have been abrogated unless the legislative enactment is in the clearest and most unequivocal of terms” and by the minority that we should resist “the temptation to construe a statute in the light of the common law, to qualify a statute by an equitable doctrine alien to the purpose ... which the statute sought to achieve.” The minority warns that common law views of fairness must give way to a conscious choice of legislative policy. The majority appears to do exactly the opposite.

55 Sharpe, supra note 17 at 15 states (perhaps too optimistically): “... one might take as an example of rules the regime of priorities established by personal property security legislation. The body of law has many complexities and subtleties and it may be difficult to provide a complete statement of the rules, but no one would argue against the proposition that there are rules which, once identified, provide answers, leaving little or no room for the application of judicial discretion.”


The general principles of interpretation used in the cases are of limited assistance if taken out of the context in which they are applied. As a relatively recent application I have chosen Rawluk v. Rawluk.\(^{59}\) In Rawluk a couple had worked together for 25 years in a farming business. Their principal asset was a farm. The farm was registered in the husband’s name. The farm at separation had a value of approximately $400,000. The Ontario Family Law Act, 1986 provided for the property owned by the spouses to be valued at separation and for an equalization payment to be made as an adjustment between them. Following this statutory approach, and if one used legal ownership as the criteria for the calculation under the act, the wife would have normally received an equalization payment in the range of a few hundred thousand dollars while the husband would have been left with 100% legal ownership of the farm.

Half the value at separation of the family assets was the general legislative intent. But there was an extraordinary circumstance here which the statute had not anticipated. There was a great inflation in the value of the farm between the date of separation and trial. By the time of the appeal to the Supreme Court of Canada the farm may have been worth in the range of $10,000,000\(^{60}\) or 25 times what it had been worth 6 years earlier at separation. The wife argued the farm was as much hers as it was the husband’s. Why should she get a few hundred thousand dollars out of the farm and the husband walk away with millions? Could the common law be used to avoid this result?

The court by a narrow majority held that it could. It did so on the basis that the Family Law Act, 1986 did not specifically deal with how the ownership of property was to be determined. It was held that the doctrine of constructive trust went to issues of ownership. The majority held that the wife was half owner of the farm under that doctrine. Although there were technical arguments advanced as to why this should be so, including the specific wording of the statute, one senses that the heart of the reasons that led the majority to hold as it did are found in Mr. Justice Cory’s conclusions:

...A marital relationship is founded on love and trust. It brings together two people who strive and sacrifice to attain common goals for the benefit of both partners. When it is terminated and acquired assets are to be divided, then in this of all relationships the concept of fairness should predominate in making decisions as to ownership. ... Where the application of the principle would achieve the goal of fairness it should not be discarded unless the pertinent legislation makes it clear that the principle is to be disregarded.

The Family Law Act, 1986 does not constitute an exclusive code for determining the ownership of matrimonial property.... The application of the [constructive trust] remedy in the context of the Family Law Act, 1986 can achieve a fair and just result. It enables the courts to bring that treasured and essential measure of individualized justice and fairness to the more generalized process of equalization provided by the Act.\(^{61}\)

---


\(^{60}\) The wife, two months after the Supreme Court of Canada decision, sold her half interest for $5,700,000. The Ontario real estate bubble burst. The purchaser did not close the transaction: Rice v. Rawluk (1994), 8 O.R. (3d) 696 (Ont. Gen. Div.).

\(^{61}\) At 180.
Interpreting the statute in the context of the relationships it governed and its overall purpose allowed residuary equitable concepts to be used to better effect the statutory purpose.

The minority disagreed. On a technical basis it was held that the doctrine of constructive trust did not go to ownership. It was a remedy to prevent unjust enrichment. It was true that the inflation in value post-separation was a windfall to the husband. However, there was no corresponding deprivation to the wife. If there was a perceived unfairness the court had a limited statutory ability in the Family Law Act, 1986 to adjust equalisation payments. That must be taken to be the only power it had. The minority viewed the Family Law Act, 1986 as a “comprehensive statutory code” which provided “complete compensation for the wife’s contribution”. The minority was also influenced by practical considerations. “Grafting the remedy of constructive trust onto this scheme would add uncertainty and promote litigation featuring detailed inquiries into how much each party contributed to the acquisition, preservation, maintenance and improvement of the property to the end of having the court declare a constructive trust in one of the parties”.62 In Rawluk, after all the arguments, a choice based on wisdom, experience and instinct was made. By a narrow majority fairness prevailed given the particularized context of the statutory wording, the relationship being impacted by the judicial decision and the nature of the equitable principle which was used to supplement the statutory regime.

In the following sections references will be made to equitable principles which may arise in the context of priority disputes and as to how such doctrines interact with the priority rules under the PPSA. Given that the BIA respects provincial law relating to security interests, the discussion below is, with some exceptions, of equal application to the bankruptcy and non-bankruptcy contexts.

A. Unjust Enrichment

The modern Canadian doctrine of unjust enrichment arose out of the unsatisfactory provincial statutory provisions which existed as late as the 1970s relating to property division on matrimonial breakdown. The application of the doctrine has, for some commercial lawyers, grown uncomfortably large since then. The three step test in Becker v. Pettkus63 has assumed almost the force of statute. “The test as to whether there is an unjust enrichment without juristic reason is flexible and the factors to be considered will vary”.64 The law is subject to the criticism that it may be a device “for doing whatever is fair between the parties”65. There can be strong disagreement as to whether the proper remedy for enrichment should be proprietary or sound in damages.66

62 At 191.
65 Ibid. at 643-4 (per McLachlin J.).
66 e.g., International Corona Resources Ltd v. Lac Minerals Ltd., [1989] 2 S.C.R 574.
Often it seems practitioners are left with statements that are so general that they are devoid of any real content when it comes to advising clients as to how a court will decide a case or what would be a reasonable settlement.67

Particular difficulties emerge in the application of the law of unjust enrichment to insolvencies. Although a proprietary award may be appropriate to deprive a wrongdoer of gains, it is not at all obvious that proprietary relief should be used to change priorities on insolvencies.68 The statutory framework normally requires assets of the debtor to be dealt with in accordance with the provincial security priority rules and, if there is residual value after the payment of such claims, for such value to be allocated to preferred creditors and then to unsecureds on a pro-rata basis pursuant to the provisions of the BIA. This general scheme of distribution may be perceived by particular creditors to be unfair in particular circumstances. Claims of priority have thus been advanced by unsecured creditors in a great number of cases. In some of the cases priority was given by way of an imposition of constructive trust over specific assets69 or even as a general charge.70 These cases effectively give priority over other unsecured creditors on the basis that, notwithstanding the general rule that unsecured creditors share rateably, the bankrupt’s property under Section 67(1)(c) of the BIA does not include property held in trust and that property over which a constructive trust is imposed does not form part of the bankrupt’s estate. In essence, like the majority in Rawluk, they approach the question of constructive trust as one going to ownership of assets.

In later Canadian cases lower courts have tended to decline to re-alter priorities.71 The approach has been that, with rare exceptions, statutory


priorities are a juristic reason for enrichment.\textsuperscript{72} Even if unjust enrichment exists, proprietary relief by way of a constructive trust or equitable lien is only to be granted if the creditor had a reasonable expectation of having a proprietary interest in the assets over which a trust is sought.\textsuperscript{73} A constructive trust is not to be imposed in order to assist a creditor that did not adequately protect itself in advance by receiving security. In the area of unsecured claims a strong tendency to avoid re-allocation of losses post-insolvency has emerged. The statutory jurisdiction to do so has been doubted. The wisdom has been questioned. It is felt that such a re-allocation may be unfair to other creditors. It is apparent that courts have also been heavily influenced by practical considerations relating to the administration of estates and to the burden such claims put on the publicly financed court system. Although a pattern may be seen in the recent case law, it is by no means the case that a final consensus has emerged. This is for a variety of reasons. The full implications of Rawluk in an insolvency context have not been canvassed by the Supreme Court. Further, the instances in which such claims can arise are so varied that it may be unwise to set out blanket rules which can only be found to be lacking as new fact situations arise. It may be more prudent to consider claims on an individual basis and then, with the benefit of experience, to try to formulate generalized principles which may assist in giving structure to whatever discretion might exist in this regard. For the purposes of this article I will look at four arguments which are grounded in the concept of unjust enrichment and discuss their possible interaction with the PPSA.

(i) \textit{Registration Errors}

The most common example of a possible unjust enrichment occurring under the PPSA is when a secured creditor's failure to perfect or maintain perfection due to an error benefits a subsequent secured creditor or the trustee as the representative of all creditors. Unjust enrichment often protects persons from the consequence of mistakes.\textsuperscript{74} The technical question which arises is whether the PPSA statutory provisions allow for such a doctrine to be considered and, if they do, whether the PPSA provides a juristic reason for the enrichment such that the enrichment is not unjust.

It is first noted that the PPSA has two specific sections dealing with the correction of errors relating to registration. Under the curative provision,


\textsuperscript{73} \textit{Barnabe v. Touhey}, \textit{supra} note 71 at 478 (O.R.); \textit{Baltman v. Cooper's & Lybrand Inc.}, \textit{supra} note 71 at 49 (C.B.R.).

\textsuperscript{74} e.g., R. Goff \& Jones, \textit{The Law of Restitution}, 4\textsuperscript{th} ed. (London: Sweet \& Maxwell, 1993) at 39: "a benefit may be conferred on another under mistake ... the benefit is then non-voluntary...In these cases the other's enrichment is \textit{prima facie} an unjust enrichment".
section 45, the court can correct an error in the form of a registration if the error was not "materially misleading". Subsection 30(6) is a self-help curative power. Under this section if a registration has become unperfected the secured party by re-registration can assume its prior priority provision subject to any security interests in the collateral which may have arisen during the intervening period of non-perfection. It is unclear whether subsection 30(6) can be used to allow re-perfection to a retroactive date of a security interest that has been mistakenly discharged. One case may suggest it cannot but one authority suggests it does.

Both sections 45 and 30(6) allow some relief against mistake in the circumstances in which they apply. Correction of some registration related errors, whether by the court or by the secured party itself, is thus part of the PPSA. There are, however, gaps in the provisions. Even if subsection 30(6) can be used to allow re-perfection of an inadvertently discharged security interest, there will be certain circumstances where it cannot be used. The secured creditor may not discover its mistake until after bankruptcy. By then, on prevailing law, it will be too late to re-file under subsection 30(6) in an attempt to re-institute priority as the priorities of competing security interests must be determined as of the date they come into conflict. Can equity intervene in such an instance to prevent possible unjust enrichment?

A useful starting point for this discussion is a mortgage case: Central Guaranty Trust v. Dixdale Mortgage Investment Corp. To state the reasons of Dixdale is to state why the Ontario Court of Appeal held as it did. The plaintiff held a first mortgage against a property under which it was owed $300,000. The property was in the Ontario Registry Act system. The defendant was the second mortgagee. The second mortgage was $180,000. The first mortgage went into default. While the mortgage was in default the plaintiff as a result of a clerical error inadvertently registered a discharge of the first mortgage on title. No one realized the error. No one in any way relied upon it. Some time prior

75 There are differences between the Ontario PPSA and those of many other provinces in this regard. The Ontario PPSA deals with security interests which are "unperfected". Other statutes provide the effect of certain events is a loss of "priority". At least one case, Re Hewstan (1996) 12 P.P.S.A.C. (2d) 36 (B.C.S.C.), holds that a security interest which "loses priority" under such a regime is not subordinate to a trustee in bankruptcy.

76 There is no need that the intervening secured creditor show actual reliance on the register.

77 Heidelberg Canada Graphic Equipment Ltd. v. Arthur Andersen Inc. (1992), 7 B.L.R. (2d) 236.

78 Ziegel and Denomme, supra note 6 at 237, and supra note 25.

79 Sperry Inc. v. Canadian Imperial Bank of Commerce (1985), 17 D.L.R. (4th) 236 (C.A.). It is also the case that the position of the secured creditor vis-à-vis a trustee has to be determined as at the date of bankruptcy. This is another reason why registrations post-bankruptcy should not be able to alter priorities.


to closing under power of sale the defendant found to its delight that the plaintiff’s mortgage had been discharged. The defendant claimed priority, relying upon the Registry Act which provided in Sections 70 and 71 a general rule of priority by registration. The exceptions to the priority to registration rule did not apply to the particular facts of the case.\(^\text{82}\) If the provisions of the Registry Act alone were considered the defendant’s position was “unanswerable”.\(^\text{83}\)

Despite the priority afforded by the statute, the Court of Appeal held that the plaintiff was entitled to first payment out of the proceeds of sale under the doctrine of unjust enrichment. In an “appropriate” case a court could give effect to the principle of unjust enrichment despite the terms of a statute. The plaintiff had suffered a loss from the inadvertent discharge — it no longer had a first mortgage. The defendant had been enriched — it now had a first mortgage. The issue was whether the enrichment was unjust. The defendant argued that it was not. The enrichment flowed from the wording of the statute. An enrichment mandated by statute could not be unjust. The Court of Appeal disagreed. It was held it “should weigh the objective of fulfilment of the purpose of the legislation against the common law purpose of preventing unjust enrichment”.\(^\text{84}\) At the level of principle the issue was “whether recognizing the plaintiff’s claim undermined the purpose of the statutory provisions in question”. It looked to the policy behind the Registry Act priority rules. It was held that the policy was to protect persons who actually relied on the registry abstract in their dealings with land. The defendant had not actually relied. “In principle”\(^\text{85}\) the court did not think the Registry Act should preclude the claim. In its view the plaintiff’s unjust enrichment claim was not one which the statute expressly or inferentially prohibited. Allowing the plaintiff to recover would not undermine the purpose of the legislation.\(^\text{86}\)

If one confines Dixdale to a consideration of the equities as between the plaintiff and the defendant the result is fair. The defendant had not in any way actually relied upon the mistaken discharge. It had not acquired any rights to the property following the inadvertent discharge. But are there larger issues present? The plaintiff was a large financial institution. It had made a mistake in registering the discharge. It was, in the result of the case, able to avoid the

---

\(^\text{82}\) Nor does the Registry Act have a provision similar to subsection 30(6) allowing a later registration to cure a previous error.

\(^\text{83}\) Dixdale, supra note 80 at 148. What is more, under subsection 56(8) of the Registry Act the registrar shall, when satisfied that a document purporting to discharge a mortgage in fact validly discharges it, delete the mortgage from the registry. Under subsection 56(10) when this occurs the land described in the mortgage is “not affected by any claim under the mortgage”. In addition to sections 70 and 71, subsection 56(10) might well seem to defeat the claim. This section is not referenced in the judgment.

\(^\text{84}\) Ibid. at 148, relying upon Maddaugh and McCamus, The Law of Restitution at 313-4. The statement there is found in the context of ineffective or unenforceable contracts. The court extended it to secured transactions.

\(^\text{85}\) Ibid. at 149.

\(^\text{86}\) Ibid. at 149.
consequences of its negligence. This result occurred after considerable litigation costs. If one hypothesises a mortgage industry dominated by sophisticated financial institutions one might well ask: Is the system best served as a whole by litigating issues of actual reliance relating to erroneous discharges? Questions of reliance are often factually intensive and costly to litigate. Is not the system better served by letting losses fall where they may on the theory that they will either be spread across the system as a whole or that the truly inefficient will be forced to improve their clerical practices if they are to compete successfully? Isn’t compliance with simple registration requirements a relatively modest price to pay for the substantial benefits which flow from being a secured creditor?87

_Dixdale_ can be confined to its facts, to the particular weak effect of registration under the _Registry Act_88, to the lack of specific statutory provisions dealing with mistakes in registration and to the statutory purpose of that act. But it may offer some hope to a secured creditor who becomes unperfected under the _PPSA_. It is of importance to note the actual form of relief granted in _Dixdale_. The plaintiff in _Dixdale_ claimed an “equitable interest” in the proceeds of the sale under the doctrine of constructive trust.89 The form of order declared it had an “interest” in the proceeds.90 This is wording reminiscent of an equitable lien.91 If one translated this wording to the context of the _PPSA_ in a similar circumstance we would have a lien imposed by “rule of law” and a lien which may be argued to be entirely outside of the scope of the _PPSA_.

If one considers a registration under the _PPSA_ that has become unperfected and that has not been re-perfected under subsection 30(6) prior to bankruptcy, the specific statutory rules indicate that such an interest is subordinate to perfected security interests and to the trustee in bankruptcy. It might be thought that if the rationale in _Dixdale_ was applied, relief would be given to reinstate priority. In the author’s view that would be a very great mistake. There is a serious risk associated with taking a decision relating to a radically different registration statute and applying it to the _PPSA_. As a matter of statutory interpretation, the attempt to impose an equitable doctrine which effectively alters the statutory priorities of the _PPSA_ must, in the context of the overall purpose of the _PPSA_, be seen to be contrary to express provisions of the _PPSA_. It is circular to argue that making a claim for an equitable lien allows one to escape the _PPSA_ entirely. That lien can only arise if enrichment is unjust. That

---

87 J.S. Ziegel, “Protecting the Integrity of the Ontario Personal Property Security Act” (1987) 13 C.B.L.J. 359 at 372-73. Query, if the debtor had gone bankrupt and the financial institution had sought to claim in bankruptcy as a secured creditor would it have succeeded?

88 Under the _Registry Act_, for instance, one takes subject to unregistered interests in land if one has actual notice of them. The opposite is the case under the _PPSA_.

89 Ibid. at 144.

90 Ibid. at 153.

91 Ibid. at 144. Maddaugh & McCamus, _supra_ note 68 at 100-102, states: “an equitable lien creates a charge on such asset to secure payment” and “may be available to parties entitled to restitutionary recovery”.
process itself requires a consideration of the law, the PPSA, that would otherwise govern. There is every reason to state that a priority given by the PPSA is a juristic reason for the benefit being conferred and that the doctrine of unjust enrichment therefore has no application.92

Further, from the point of view of fairness there is often little distinction between cases where there has been an inadvertent loss of perfection and instances where there has been an inadvertent failure to register or a defective initial registration. In all instances there is a potential for windfall. The law is clear that the priority goes to the registered secured party despite whatever actual knowledge it may have had and despite the fact that a windfall might be seen to occur.93 Consistency suggests the same result in all cases involving registration. One should not be able to argue in regard to defective registrations or registrations which have become unperfected, that there is some general power, outside of section 45 or 30(6) to reinstate a party to priority. These sections must be taken to define jurisdiction.94 “The efficacy of alternative remedies conferred by the applicable legislation must be examined to determine whether a declaration of constructive trust should be declared”.95 Perceived gaps in the protections afforded to secured creditors should not disguise the fact that the legislation as a whole is favourable to them. A party who has failed to properly perfect or to remain perfected should not be able to escape the consequences of its own mistake by claiming in unjust enrichment.96 To the extent a change in this result is perceived to be advisable it is for the legislature to change the PPSA as it relates to registration errors.97

---

92 Authorities at supra note 71. Similarly, the law is normally that if money is paid to a creditor in reduction of its indebtedness the creditor is under no obligation under the law of unjust enrichment to repay the money to a third party who might have a claim to it. E.g., Re Ontario Egg Producer Marketing Board and Clarkson Co. Ltd. (1981), 125 D.L.R. (3d) 714; Toronto Dominion Bank v. Bank of Montreal (1995), 22 O.R. (3d) 362. This is even the case if the money has been stolen or defrauded from the third party. Cherington v. Mayhew’s Perma-Plants Ltd. (1990), 71 D.L.R. (4th) 371 (B.C.C.A.), Royal Bank of Canada v. Harowitz, supra note 71.


94 Re Best (1997) 33 O.R. (3d) 416 (no unjust enrichment as a result of loss of priority due to registration error). In Strathcona Brewing v. Eldee Investments, supra note 93, the court relied upon, in part, that the Saskatchewan equivalent to s.30(6) was a complete code of protection with respect to erroneous discharges.

95 Rawluk, supra note 59, per McLachlin J. (in dissent) at 192.


97 e.g., the different approach in British Columbia as referenced in Cuming and Wood, supra note 9 at 358.
A further consideration which may suggest this result is the harmonisation of priorities in bankruptcy and non-bankruptcy situations. Although there are a number of instances where a receiving order flips priorities, it seems reasonable to suggest that these instances should be kept to a minimum. An attempt to judicially impose an equitable lien in a bankruptcy context runs the risk of possibly being inconsistent with s. 70(1) of the BIA which provides that the receiving order is to take precedence over "all judicial or other attachments,... judgments operating as hypothecs, executions or other process against the property of the bankrupt, except those that have been completely executed by payment... and except the rights of secured creditors". The provision stops the race by unsecured creditors who are seeking priority against a debtor’s assets. The inclusion of the words “judgments operating as hypothecs” in the section suggests that a party who is claiming (or who has received) a judgment which judicially imposes a change over an asset is subordinate to the trustee unless the realisation process is complete at the date of bankruptcy. If this is the case it may logically follow that claims of this nature should not be entertained in the administration of the bankruptcy.98

As at writing, only one reported case has considered Dixdale in the PPSA context: Frankel v. Canadian Imperial Bank of Commerce.99 The debtor had granted a security interest to the CIBC. The CIBC’s security was registered first. It initially had priority. The debtor also granted a secured interest to his father. That registration had lapsed. The CIBC discharged its registration as a result of a clerical error. The debtor owed his father money and was considering bankruptcy. The debtor’s accountants told him the CIBC registration had been discharged. The debtor then gave his father a further GSA virtually identical to the first. The father registered a new financing statement. The father professed no actual knowledge of the CIBC’s unregistered security. The debtor went bankrupt. CIBC then discovered it had inadvertently discharged its registration.100 It claimed priority over the father on a number of bases, including a claim that the father had been unjustly enriched as a result of the clerical error in discharging.

Cameron J. rejected this claim on the facts. But his reasons for so doing may create more problems than they solve. After noting with apparent approval the approach in Dixdale he stated:101

...the PPSA is intended to protect persons who in dealing with secured interests in person,102 rely on registration certificates ... I have no evidence of any sharp practice or unfair dealing by either party ...I cannot find on the evidence ... that (the father) had

100 Had CIBC discovered its error prior to bankruptcy it could have attempted to reperfect under subsection 30(6). The success of such a step would have depended on whether: (i) subsection 30(6) can be used to correct inadvertent discharges; and (ii) whether the father had acquired an interest in the collateral in the interim.
101 Ibid. at 254.
knowledge of the son’s impending bankruptcy. The facts of this case do not justify invocation of the principle of unjust enrichment to force restitution to CIBC (by the father). The juristic reason for the enrichment of (the father) is the perfection and priority provisions of the PPSA and the negligence of CIBC.

There are difficulties with this statement. First, although it is true that one of the purposes of the PPSA is to allow persons to rely upon security searches, actual reliance is in no way required to found priority. Had the father registered, knowing of the bank and (incorrectly) believing he was second in statutory priority under the PPSA he would still have been entitled to priority. The judge’s reasons seem to invite factual investigations of whether reliance did or did not occur. Second, the decision suggests that the law of unjust enrichment might be available to alter priorities in the PPSA if the facts are sufficiently bad: if there has been “sharp practice”. Again, this potentially opens up a large area of factual investigation. It threatens to inject a wide ambit of judicial discretion relating to what conduct is deserving of censure and whether that censure should extend to a reversal of statutory priorities. There is a suggestion that taking knowing advantage of another’s mistake relating to registration may be enough to invoke this principle. That cannot be right. The decision then concludes with the comment that the PPSA itself provides a juristic reason for the enrichment with the implication that an enrichment that flows from the PPSA can not be unjust. Although this is the proper foundation for the decision, it is lost in the other statements made. In the author’s view neither a unilateral mistake relating to registration nor a party knowingly taking advantage of that mistake should be a basis for upsetting the statutory priorities in the PPSA.

(ii) Equitable Subrogation

The doctrine of subrogation in this context deals with circumstances where a third party has paid off the debt of a secured creditor and seeks to be put in the same position as that formerly occupied by that creditor. An advancing creditor normally has the ability to secure an assignment of the other creditor’s secured position or can take security to its own satisfaction. It does not need to advance unless its security conditions are met. However, on occasion, advancing creditors do not, as a result of a registration related mistake, receive the security they bargained for. A windfall to a subsequent registered secured creditor who moves up in priority, or to a trustee in bankruptcy, may result.

The negligence of solicitors has provided ample recent opportunity to explore the parameters of subrogation in the context of mortgages. It has been held that the doctrine continues to apply in Ontario both with respect to lands

103 Authorities, supra note 93.

104 Even the non-Ontario statutes which have “good faith” provisions, supra note 15, provide that “a person does not act with bad faith merely because the person acts with knowledge of the interest of some other person.” Note, however, that fraudulent conveyance legislation may be applicable to security granted on the eve of an insolvency.
governed by both the Ontario Registry and Land Titles Acts\textsuperscript{105} in order to avoid the unfairness that would otherwise result. The remedy was granted in two of the cases, although it was denied in the third as it was held (rather unconvincingly) that the subsequent secured creditor had relied upon the register and that the discretionary remedy should therefore be refused.

The equitable subrogation cases are a species of unilateral mistake: The secured party has failed to properly register with a consequent windfall to another party. The same tension between individualized fairness and the preservation of the integrity of registration statutes exists. In the author’s view, for the same reasons as expressed above, equitable subrogation should not be used to re-alter statutory priorities under the PPSA.\textsuperscript{106} To allow this doctrine to be invoked would in many cases require a detailed factual investigation into actual reliance. If a creditor has failed to secure adequate security for an advance it should either bear the loss itself or seek recompense from the solicitors who have been negligent in their professional obligations.\textsuperscript{107}

(iii) Knowing Receipt by Secured Creditors of Trust Property

The doctrine of knowing receipt of trust property provides that if a party receives property which it knows or ought to know is trust property it is under an obligation to disgorge that property to the beneficiary.\textsuperscript{108} The rule makes obvious sense. If a bank knows that the trustee of an estate is using trust funds to repay a personal debt to the bank, the bank cannot be allowed to keep the trust funds. The application of this trust concept in the commercial world is, however, filled with difficulties. Security agreements\textsuperscript{109} frequently have provisions requiring that the proceeds of disposition of inventory over which a secured party has security be held in trust for the secured party. In\textit{Flintoft v. Royal Bank}\textsuperscript{110} the Supreme Court held a trust provision would give a secured


\textsuperscript{106}There are no Canadian cases exactly on point of which I am aware. In Westpac Banking Corporation v. The Duke Group Limited (in Liquidation) (1994), 20 O.R. (3d) 515, equitable subrogation was not allowed to re-alter priorities on an insolvency. The case did, however, involve unusual facts.

\textsuperscript{107}Ziegel & Denomme, supra note 6, are of a different view at 245-7 ("Subrogation ... is implicitly recognized in s.72 of the Act ... ").

\textsuperscript{108}A related but distinct rule deals with knowing assistance of a dishonest breach of trust: \textit{Re Air Canada v. M&L Travel Ltd.}, [1993] 3 S.C.R. 787.


\textsuperscript{110}[1964] S.C.R. 631, dealing with Bank Act security. \textit{Flintoft} was referred to without disapproval in \textit{Re Giffen}, supra note 5.
creditor's interest in proceeds priority over a trustee in bankruptcy even if the secured creditor had failed to properly register its interest under the applicable registration statutes.

In the real world it is the case that trust provisions are routinely ignored by all concerned if the credit is operating normally. One senses that in many instances debtors do not even know there are trust provisions buried in the fine print of security agreements. Most usually the funds are deposited in the ordinary course in an operating account at a bank without any complaint by the secured party. On an insolvency, a secured party who has done nothing to enforce the trust provisions will often make a complaint that a bank is in knowing receipt of trust property. Notwithstanding the lack of scrutiny by the secured creditor, the law is that if the appropriate wording has been included in the security agreement that the funds received on the sale of the inventory involved will be trust funds.¹¹¹ Common law principles would provide that if a bank with actual or constructive knowledge of the existence of the terms of a security agreement with trust provisions applied such inventory proceeds against an overdraft, it would be liable to the secured party under the doctrine of knowing receipt.¹¹²

Common law considerations are not, however, the only considerations which impact. The PPSA governs the priority of competing security interests in inventory prior to disposition and in the proceeds after disposition. Under section 25(1) of the PPSA the inventory financier would have priority over the bank to the proceeds of inventory disposition if it had had priority in the original collateral and if the proceeds were “traceable” or “identifiable”. In circumstances where an inventory financier is first to perfect or validly registers a PMSI, both the common law trust rules and the PPSA lead to the same result: priority to the inventory financier over the bank. However, if an inventory financier has not perfected, the PPSA provides priority to the proceeds to a bank which has perfected.¹¹³ In such a case, a conflict effectively arises between the PPSA priorities and the common law “knowing receipt” doctrine. The knowing receipt of trust property doctrine appears to provide that the bank is liable to the inventory financier for the value of the trust property received.

In approaching a solution to this problem we must start by noting that the insertion of trust requirements in regard to proceeds is an attempt to give the inventory financier better control over and security against the proceeds. It is part and parcel of the security interest granted in the original collateral.¹¹⁴ It is entirely inconsistent with the purpose of the PPSA to allow the form which a secured creditor has decided to create its security interest to relieve that party from the normal perfection requirements and priority rules under the PPSA. It

¹¹¹ In some cases it might be argued that the trust relationship was waived as a result of a course of conduct.
¹¹³ S. 25(1).
makes no sense to hold that if the inventory financier does not have priority to the collateral prior to disposition, that it can claim after disposition against the bank on the basis of knowing receipt of trust property and thus effectively put itself in a priority position.\footnote{Accord Bank of Nova Scotia v. Gaudreau (1984), 48 O.R. (2d) 478 at 518-519 (anomalous to apply tort of inducement of breach of contract to reverse statutory priorities, priority under PPSA constitutes "justification" which defeats such a tort claim). But note there is a contrary view. Ziegel & Denomme, supra note 6 at 230 state that this statement "reads too much into the rule" and, at 185-6 suggest there may still be room for a constructive trust to be imposed. Indeed, section 72 of the PPSA was enacted after a 1985 Supplementary Report of the Minister’s Advisory Committee (Queen’s Printer,1985) which (at 96) indicated that the section was in response to the judicial statement in Bank of Nova Scotia v. Gaudreau that the PPSA was a “complete code”.} Most of the knowing receipt cases have involved debtors who were insurance agents or travel agents.\footnote{e.g., Canadian Pacific Airlines Ltd. v. Canadian Imperial Bank of Commerce (1987), 61 O.R. (2d) 233, aff’d 71 O.R. (2d) 233; Ontario Wheat Producers Marketing Board v. Royal Bank (1984), 41 O.R. (2d) 294 (Gen. Div.), aff’d 46 O.R. (2d) 362 (C.A.).} In such an instance the agent is selling the assets of the principal. These cases do not involve situations where the debtor is re-selling inventory sold in which the supplying party has a security interest.\footnote{Exceptions are Bank of Nova Scotia v. Bank of Montreal, supra and C.I.B.C. v. Valley Credit Union, supra note 109. In the first case, Bank of Nova Scotia had a registered PPSA security agreement which provided that proceeds of inventory sales were to be held in trust for it. Bank of Montreal received such proceeds. The decision found liability on a knowing receipt basis. An alternative (and it is submitted preferable) approach would have been to give Bank of Nova Scotia priority under the PPSA sections dealing with proceeds. The second case was argued on the basis of “knowing assistance”, not “knowing receipt”.
} Nevertheless, one can anticipate circumstances where an inventory financier who has been lax in perfecting its security will claim against a bank on the knowing receipt of trust property basis. It is submitted that where this claim arises out of a security interest, it should be firmly rejected.\footnote{Credit Suisse Canada v. 1133 Yonge St. Holdings (1996), 28 O.R. (3d) 670 (Gen. Div) (“The bank’s perfected security interest in the proceeds is not lost because the proceeds are held in trust for the owner”), reversed on other grounds [1998] O.J. No. 4468. This was not a case of competing security interests.} The theoretical underpinning for knowing receipt liability is the doctrine of unjust enrichment. Given that the PPSA provides priority to a bank in such an instance, the bank’s “enrichment” as a result of a debtor’s breach of trust is not “unjust”. To attempt to apply the common law concept of “knowing receipt” in such a context would lead to a result inconsistent with the express provisions of the PPSA.\footnote{This does not mean that knowledge is irrelevant for all purposes in proceeds priority disputes. If the contest is between a perfected security interest of proceeds and a transferee of the proceeds, the state of the transferee’s knowledge is important, at least in Ontario. Ziegel & Denomme, supra note 6 at 188-90.}

A variation of this analysis may be needed on bankruptcy. Under section 67 of the BIA, trust property does not form part of the bankrupt’s assets divisible among creditors. It might be argued that on bankruptcy an inventory financier
with trust provisions, even in the absence of proper registration, has priority on bankruptcy over a perfected security interest. It is submitted this is incorrect. If the conflict is between two secured creditors the fact of bankruptcy should have no impact on the priority of secured parties as amongst themselves to proceeds.¹²⁰

(iv) Involuntary Creditors/Debtor Misconduct

The actual allocation of losses amongst creditors on an insolvency will depend on the debtor’s actions prior to bankruptcy. The debtor will pay the debts of certain creditors and not others. It will grant security to some and not to others. Creditors must be taken to have knowingly accepted risks associated with ordinary course debtor actions. Difficult questions may arise, however, where the debtor’s conduct is outside the reasonable expectations of creditors. Not all debtors conduct their affairs honestly. In certain instances, specific statutory provisions relating to fraudulent conveyances and preferences may deal with debtor misconduct which has unfairly shifted losses as amongst creditors. There is, however, a wide range of possible misconduct which is outside specific statutory provisions. A common example occurs where a debtor has acted fraudulently in securing credit and where the debtor’s assets (and possibly the position of certain secured creditors) has been enhanced by such a fraud. In such an instance a creditor who has suffered as a result of fraudulent activity may claim that it should recover its loss under the doctrine of unjust enrichment. It may claim a right to trace assets and a constructive trust or an equitable lien. A variety of arguments can be used. Creditors may argue that they should be restored to a secured position which they were induced by fraud to relinquish,¹²¹ that assets purchased by the debtor with funds fraudulently obtained should be impressed with a constructive trust and do not form part of a bankrupt’s estate given the provisions of Section 67(1)(a) of the BIA,¹²² that goods fraudulently obtained by the debtor in fact are inequity deemed to be held in trust for the creditor and hence do not form part of the bankrupt’s estate or that title to goods did not, because of the fraud, truly pass.

¹²⁰Note, however, if the contest is between the unperfected inventory financier and the trustee, the inventory financier may, by analogy to Flintoft, win. In Bank of Montreal v. Dynex Petroleum (1997), 145 D.L.R. (4th) 499 (Alta. Q.B.), counsel, although not agreeing that a trust existed, may have agreed that had such a trust existed it would have had priority on bankruptcy over a bank’s perfected GSA given the impact of section 67 of the BIA. It is submitted, one needs to look at how the trust over the proceeds arose: if it arose out of a security interest no priority should exist.


Although the modern law of unjust enrichment is a relatively new creation, there is some historic precedence for giving effect to unjust enrichment arguments in bankruptcy. The rule in *Ex Parte James*\(^{123}\) provided that trustees in bankruptcy should not be able to take advantage of fraud "in circumstances where the bankrupt estate has been enriched at the expense of the person making the claim and to permit this to happen would be unfair and inequitable, even though it might be perfectly legal".\(^{124}\) Its basis was that a trustee in bankruptcy as an officer of the court had a special obligation to do equity. There is some limited Canadian authority allowing priority to creditors on this basis.\(^{125}\) The cases break down into two categories. In certain cases the enrichment of the estate has occurred post-bankruptcy where, for instance, a mistaken payment has been made to a trustee\(^{126}\), where a service has been performed to the benefit of the trustee, or where a party has refrained from action as a result of a representation by a trustee. These cases arguably do not involve any special insolvency considerations. The question instead deals with the personal liability of the trustee to pay the claim (albeit then with a right of reimbursement against the estate). More difficult questions arise, however, when it is sought to extend the circumstance to debtor misconduct prior to insolvency occurring. Attempting to extend the rule, by analogy, to secured creditors who have benefited from debtor misconduct is even more problematic given the possibility that a defence by way of change of position or bona fide purchase for value may arise.

Despite the *Ex Parte James* precedent to support such claims, recent Canadian cases have tended to reject creditor requests for the imposition of special priority as a result of debtor misconduct.\(^{127}\) They have left losses as a result of debtor fraud in the securing of credit or the acquisition of assets to remain where they occurred and have refused to re-allocate losses. The approach which has emerged is that consensual creditors must look after their


\(^{124}\) *Re M.C.C. Products Ltd.* (1972) 17 C.B.R. (N.S.) 28 at 36.


\(^{126}\) The facts in *Ex Parte James*. Indeed, the rule in *Ex Parte James* was a way of getting around the 19th century limitations in the law on recovery of monies paid by mistake.

\(^{127}\) Authorities at supra notes 71 and 92. There are exceptions. A very sympathetic case on unusual facts is *Re Sefel Geophysical Ltd.*, supra note 69.
own interests and that the contractual relationship which normally exists between creditors and the debtor, even if impacted by fraud, is a "juristic reason" for the enrichment of the debtor's other creditors. The creditors have been left with whatever in personam claim they have against individuals who have perpetrated the fraud. They have not been given priority, either over a trustee or a secured creditor, to specific assets on insolvency. In the author's view the bases for such decisions are eminently sound.

It may be appropriate, however, for exceptions to exist to this general approach. The strength of a claim for proprietary relief increases if the creditor is a non-voluntary creditor. An obvious example is where a theft has occurred and where the stolen asset has been converted into some other traceable asset. A number of cases have given the victims of such misconduct proprietary relief over other unsecured creditors.128 The question as to whether creditors in such circumstances should be given priority with respect to traceable assets over a secured creditor of the debtor is more problematic. If secured creditors advanced funds believing the debtor was the true owner of the converted assets the change of position defence would militate against such relief.129 However, if the secured creditor truly received a windfall, the case for proprietary relief to the non-consensual creditor strengthens. How are these values to be balanced?

Certain propositions can be tentatively stated. If a secured party stood by passively when it knew a fraud was being perpetrated by the debtor to the secured party's benefit, it should not be able to benefit from such a fraud. An analogy may exist to the inability to profit from crime130 or the knowing receipt of trust property doctrine.131 The imposition of a constructive trust in favour of the victim to give it priority over the secured creditor and to prevent the enrichment of that secured creditor would be appropriate. This would provide an avenue for relief, for instance, where

---


129 Change of position normally being a defence to imposition of a constructive trust, Maddaugh & McCamus at supra note 68. A secured creditor would not have priority to a stolen asset which remained in its original form as ownership to the asset would not have passed from the victim.


131 If this analogy is used, knowledge might include "constructive knowledge". The practical difficulties posed by liability for constructive knowledge are canvassed in B. Crawford, "Constructive Thinking?" (1998) 31.C.B.L.J. 1

a secured creditor knows that the debtor is engaged in “juicing the trades” by ordering excessive inventory from them.\textsuperscript{132} Equally clearly, if a secured creditor has changed its position, such as extending or increasing credit, in good faith and in ignorance of the facts giving rise to the claim for equitable relief, priority over that secured creditor should be refused.\textsuperscript{133} The most difficult questions exist where the secured creditor, while innocent of any knowledge of the facts giving rise to the claim for relief, has also not in any way acted to its detriment. The leading English text suggests that in such a case proprietary relief should be granted to the victim even on an insolvency.\textsuperscript{134} Such a rule would, in the real world of litigation, inevitably lead to the necessity to minutely examine the secured creditor-debtor relationship to see if some reliance may have occurred. It may also require a detailed inquiry of what it means to be an involuntary creditor. The balance between the costs and uncertainties thereby engendered and the values of individualized fairness is a difficult one. In the end, the proper balance to be struck depends, in part, on one’s view of how much litigation might be engendered and how efficient the civil litigation system is in sorting out such questions. In the author’s view it may well be that the court should not subordinate a secured party’s priority to a claim of a non-voluntary creditor of the type described here unless the secured creditor had knowledge of the facts giving rise to the claim and stood by so that it eventually benefited from the debtor misconduct.\textsuperscript{135} It must be admitted, however, that open issues exist with respect to the proper level of protection to be provided to non-consensual creditors who may have claims to proprietary relief. If the good conscience test for the creation of a constructive trust articulated by the Supreme Court in non-insolvency cases is applied to insolvencies, it could well lead some judges to conclude that a secured creditor cannot in good conscience seek to benefit from a debtor’s fraud or another creditor’s mistake. The Supreme Court of Canada has been especially vigilant in recent years with respect to its protection of the vulnerable. Involuntary creditors, by definition, are not capable of protecting themselves in advance from the consequences of debtor insolvency. It may well be, therefore, that the writer’s suggestions as to limits which should be employed in re-allocating losses as a result of debtor misconduct will not be found to be the law in Canada.

\textsuperscript{133} Soulos v. Korkontzilas, supra note 67 at 241.

\textsuperscript{134} Goff & Jones, supra note 74 at 74-8 (the discussion relates to priority over general creditors but appears to also suggest priority over secured creditors who have not changed their position).

\textsuperscript{135} S. Dunphy, “Critical Commentary on Employment Issues in Insolvencies” in Corporate Restructurings, supra note 54 at 156 (“If the insolvency system is to operate efficiently, there must be a minimum level of certainty to it. Permitting “hard luck” cases to leap to the head of the line solely on the basis of sympathies would be to erode the very foundations of the system”).
B. Equitable Subordination

In the United States a specific provision of the Bankruptcy Reform Act of 1978 directs the court to consider the possible application of the doctrine of “equitable subordination” to creditor claims. This provision is generally viewed as codifying a pre-existing practice by which American bankruptcy courts, under an inherent equitable jurisdiction, exercised a discretion to subordinate claims. In the bankruptcy context the power has been used in a wide variety of instances. Most usually it has been used to subordinate secured claims of related secured parties who have engaged in fraudulent or inequitable conduct and hence violated the “rules of fair play and good conscience”. This power has, as might be expected, given rise to a plethora of litigation. Inequitable misconduct has, on occasion, included conduct as diverse as undercapitalization of the debtor, breach of fiduciary duties in managing the debtor’s affairs, participating in misleading statements to other creditors and undue secured creditor interference in the management of the debtor.

The term equitable subordination is not a defined term in Canadian insolvency law. I will use it to refer to the possible inherent power of the court to deny a secured party its normal statutory priority as a result of some misconduct by the secured party. In considering whether a power to impose subordination should exist in the courts, it is first necessary to identify what other specific legal tools presently exist. The PPSA permits creditors to enter into consensual arrangements with one another in regard to relative priority. A party may by agreement in writing or otherwise subordinate its interest to another. There is no requirement that the party asserting a subordination be in priority, show that it relied upon or even

---

136 11 U.S.C., Section 510(c).
139 The litigation is sometimes lengthy: e.g., In the Matter of Multiponics Inc. 622 F.2d 709 (1980, 5th Cir.).
show it knew of the subordination provision.\textsuperscript{141} The consensual subordination cases may exhibit a trend of requiring that a party establish a subordination clearly and unequivocally.\textsuperscript{142} The wide enforcement given by courts to consensual subordinations suggests that creditors should bargain for priority amongst themselves rather than asking the court to impose subordination on an after the fact basis.

Powers also exist to deny or modify a secured creditor’s claim. The party must prove it is a creditor in the amount claimed. In many cases questions arise as to whether a party who professes to be a secured creditor has advanced funds by way of debt or equity. If the funds are equity, the claim of the party to be a secured creditor will be rejected.\textsuperscript{143} With the sloppy record keeping of many small debtors and with imaginative planning which goes into the corporate financing of sophisticated debtors, it will not always be easy to determine whether debt or equity is involved.\textsuperscript{144} Similarly, it is always possible that a secured party while owed a debt, may be subject to claims of set off by the debtor which will reduce or extinguish that debt.\textsuperscript{145} Where the debt is alleged to have arisen as a result of a transfer of assets or services, the value of those assets or services (and hence the quantum of the debt) must be satisfactorily proved.\textsuperscript{146}

Questions may also arise as to whether the grant of security is valid as between the debtor and the creditor. In the context of security granted by corporations to related parties there may be questions as to whether the grant of security was in the best interests of the corporation or whether it was reasonable and fair. If it was not, the security may be voidable under modern business


\textsuperscript{143} Dapper Apper Holdings Ltd. v. 895453 Ontario Ltd. (1996) 38 C.B.R. (3d) 284 (Ont. Gen. Div.).

\textsuperscript{144} e.g., Re Central Capital Corporation (1996) 27 O.R. (3d) 494 (C.A.); Canadian Deposit Insurance Corp. v. Canadian Commercial Bank, supra note 50; M. Clements et al., “Use of Distress Preferred Share Financing is Attacked” [1995] 2 Credit and Banking Litigation 76.

\textsuperscript{145} e.g., Re Olympia & York, infra note 151 (where the argument applied had to do with a rule of trust).

\textsuperscript{146} In a related party’s transfer of assets or provision of services to corporations, the valuation must be reasonable and fair under CBCA-type statutes.
corporations legislation. If other vitiating elements exist such as duress, undue influence or fraud, these may also allow the security interest to be avoided. Fraudulent preference and conveyance provisions, both provincial and federal, will provide avenues for attacking transactions which provide impermissible advantages to secured creditors. A hodgepodge of other lesser used rules may also assist.

Lastly, if one secured party has somehow participated in misleading or defrauding a creditor or the estate, a damages remedy will lie in tort. Diversion of assets from the bankrupt is one obvious example. Others exist. If a shareholder/director of a one man corporation holds a first secured position and seeks to inflate his inventory by purchases from creditors as the corporation is approaching insolvency, that individual might well be personally liable for fraud. Liability also exists if a person fraudulently misrepresents to a creditor the debtor’s ability to repay. There is nothing in the PPSA or elsewhere which gives secured creditors any immunity to damage claims from tortious activities. Determining whether, and to what extent, we need to add on to these specific remedies, a further inherent court power to equitably subordinate the claims of secured creditors depends upon the extent of the perceived inadequacies of the remedies presently available. If the tools are adequate to deal with the vast majority of cases there may be little incentive to discover a general inherent judicial power to subordinate.

Recent appellate authority has taken no firm position as to whether equitable subordination is part of Canadian law. Two decisions of first instance in insolvencies have rejected the doctrine of the court having jurisdiction on the basis that if such a power is to exist it must be created.

---

147 Attorney General of Canada v. Standard Trust (1991) 84 D.L.R. (4th) 737 (Ont. Gen. Div.) holds that a trustee in bankruptcy has no status to bring an oppression remedy claim. My view is that this decision is wrong on this point. Gainers Inc. v. Pocklington (1992), 7 B.L.R. (2d) 87 (Alta. Q.B.) holds that a corporation can be a complainant. The trustee must have the right to bring any action the corporation could have: Weber Feeds Ltd. v. Weber (1979), 24 O.R. (2d) 754 (C.A.).

148 See Crozier, infra note 151 at 43-4, for a list.


by legislative action. There is a fear it could lead to chaos in the practical administration of estates. There have been no specific references to the interaction of the possible availability of the doctrine with the PPSA but the same policy considerations arise. In the writer’s view there is much to be said for there being no court power to force a subordination. The above remedies are usually fully adequate. If they are found to be inadequate, statutory reform of perceived specific unfairness, such as the 30 day goods rule, is to be preferred to a generalized power.

An argument may exist, however, that a statutory power to subordinate has already been given by the PPSA in certain provinces. Most PPSAs provide that “a secured party must act in good faith” but that “a person does not act with bad faith merely because the person acts with knowledge of the interest of some other person.”. Even Ontario which has no such explicit provision may, by section 72, permit bad faith to be considered. Decisions considering these provisions hold they have to be interpreted in light of the overall intent that the PPSA be a comprehensive code of legislation designed to bring certainty to the secured transaction market. They hold that something more than actual knowledge by the secured party of a prior security interest is required to constitute bad faith by the secured party. There has to be a further act. The thin case law suggests that there must be some independent actionable wrong such as fraud or misrepresentation by the secured party. If this is correct, it is arguable that the good faith provision adds little of substance to the determination of legal rights. If a fraud or misrepresentation has occurred there is no need to rely on the statutory provision to grant relief. Further, if a claim of breach of a secured party’s good faith obligations towards a debtor is made it should presumptively be made as part of a damage action by the debtor (or its trustee) against the secured creditor.

One case, Carson Restaurants, has gone so far as to disallow a secured party’s claim because of that party’s alleged misconduct. In Carson Restaurants an individual controlled both the debtor and a secured party. The debtor had also granted a security agreement to an arm’s length debtor. The registration of this latter security agreement contained an error. The court found (although on what evidence is not clear) that the individual had “deceitfully delayed” the arm’s length secured party in its enforcement of its security. The court found that the error correcting provision in the Saskatchewan Act could be used to correct the erroneous registration by the arm’s length party and additionally that the court could, under the doctrine of bad faith, disallow the related party’s secured claim.


154 Supra note 153.
The "corporate veil" between the related party and the debtor was lifted. In the author's view one can doubt the correctness of the second basis of decision in *Carson Restaurants*. There was no evidence that the individual (or the related secured party) had done anything to cause the other party's PPSA registration to be in error which was the apparent cause of its loss. There was no apparent link between any delay in enforcement and the other party's loss. At most, if there had been a tortious delay in the realization of security the remedy should have been confined to damages equivalent to the extent that the value of the complaining party's security had depreciated due to the delay.

C. The Oppression Remedy

*Salomon v. Salomon and Co. Ltd.* 155 is often viewed as being the cornerstone of modern corporate law. It explicitly recognized the separate legal existence of corporations and drew a distinction between the liabilities of the corporation and the liabilities of shareholders and directors of that corporation. On its facts it also went further. It provided that a shareholder/director might, by taking appropriate security, achieve priority over other creditors on an insolvency. Even 100 years ago, this result was perceived by some judges as being unfair. 156 Some modern cases provide a similar reaction. 157 However, the result in *Salomon v. Salomon* can be justified on the basis that consensual creditors have the ability to bargain for security and to ask for contractual subordination (or PMSIs) and that if they do not they cannot complain about the secured debt structure of a corporation. There may be strong policy reasons for allowing secured creditors who are related parties to receive and exercise their security freely. Such persons may only be willing to invest in businesses in return for security. Denial of security status may deny corporations a needed source of capital. Related parties also have to be able to freely exercise their security. In many instances if a business is to survive (and if employees are to remain employed) the debt/equity structure of the business will have to be restructured. The business often has maximum value to present management. It must be the case that over the last 20 years thousands of Canadian businesses have gone into receivership or bankruptcy in circumstances where shareholders/secured creditors have bought assets from the receiver/trustee in bankruptcy and have started the business afresh.

155 [1897] A.C. 22
156 "Everybody knows that when there is a winding up debenture holders generally step in and sweep off everything; and a great scandal it is" (*Salomon* at 53). At least in retrospect, the main problem with *Salomon* is its holding that the amount owing to the related party/secured creditor could not be challenged as the corporation had agreed that the assets transferred by the related party had a particular value. The same result would not be reached today under modern business corporations legislation given the requirement that the transaction be reasonable and fair.
157 e.g., *Laronge Realty Ltd. v. Golcanda Investments*, supra note 151.
Whatever the merits of these arguments, however, there is often room for the perception that an insolvency has benefited related parties who are the most to blame for the business failure while penalizing innocent creditors. Increasingly, creditors are looking to the oppression remedy as a means of re-allocating losses. The tension between secured transaction legislation and corporate legislation is immediately apparent. The PPSA involves a conscious legislative choice of certainty over fairness. The oppression remedy reflects the opposite choice in the context of corporate affairs. There is a reason for this difference in approach. In the secured transaction marketplace there is likely to be a relatively high reliance on written agreements and on registration. Transactions tend to be discrete and arm’s length. There is the opportunity to continually bargain on the terms on which credit is supplied. Typically if the bargaining fails to reach agreement either side can walk away and seek alternatives in the marketplace. There is a need to transfer and act on secured interests. There are cost implications of injecting uncertainty. In contrast, in the corporate context there is often a large degree of informality which characterizes the relationship between shareholders, especially in small corporations. The relationship may be built on trust. It may extend over decades. There may be no easy exit for shareholders from the relationship. Unplanned for contingencies may arise. The contract between the parties may be relational in nature. It may be incomplete. There may be detrimental reliance over many years on a settled course of conduct. One party may be vulnerable to the exercise of power by another. For these reasons the legislature has given the courts, under the oppression remedy, the power to supplement the arrangements between shareholders to advance fairness. The oppression remedy allows the court to protect reasonable expectations which are not specifically set out in the corporate constitution.

Although the oppression remedy arose out of the relative vulnerability of minority shareholders to unrestricted majority rule, it is not confined to shareholders. Creditors may also rely upon it if it applies to the facts at hand. The court under the oppression remedy can grant “any remedy it sees fit to rectify a corporation’s actions which have been oppressive to, unfairly prejudicial to or unfairly disregarded” the interests of a creditor. There is the power to award damages in favour of a creditor against a director, officer or third parties. Although the normal sweep of the remedial power under the oppression remedy is very wide it is possible that the power does not extend to reversing PPSA priorities given the PPSA provision which provides that the PPSA governs in the event of a conflict with another statute.

159 e.g., CBCA s.241. For a canvass of recent creditor cases see W. Gray, “Creditor Use of Statutory Corporate Law Remedies”, (1998) IV Corporate Liability 219.
160 Section 73. A conflict of law or constitutional question of some complexity may arise if the applicable PPSA statute is of one province and the applicable business corporation act is of another province or is federal.
between the PPSA and the relevant corporate legislation it may be that the courts would be well advised to use their unquestioned power to award damages if a secured party has misconducted itself rather than attempting to exercise a questionable power to subordinate.

What guidelines should exist as to when such a statutory power under the oppression remedy should be exercised? Some preliminary observations must first be made. First, although a creditor has the status to seek leave to bring an oppression remedy application, in most cases it is unlikely that the considerations of informality, vulnerability or trust which gave rise to the need for the oppression remedy in the shareholder context will exist in the debtor-creditor relationship. The debtor-creditor relationship will often be entirely contractual in nature and the rights of the parties will normally be governed by contract. Second, to the extent that a creditor may have concerns that the corporation may have been mismanaged, its assets dissipated or some other harm done to it, the law is now relatively clear that the proper party to bring such an action is the corporation, or, if the corporation will not do so, for a derivative action to be commenced. The effect of a successful derivative action will be to have monies flow back to the corporation. These monies will then be dealt with under the applicable statutory priority rules. These same rules should apply if the complaint is that another secured creditor has by its misconduct harmed the corporation. Such an action should be brought on the corporation’s behalf. It should not form the basis of a claim by a creditor seeking subordination of a secured party’s claim or a direct award of damages in its favour. Third, in order to fit within the oppression remedy the acts complained of must be acts of the corporation or its affiliates. Acts of a secured party, even a related secured party, may often not fit within this definition.

Further, as a corporation approaches insolvency it is entirely appropriate that the directors of a corporation consider the interests of senior creditors as it is they who have the true economic stake in the enterprise. It is submitted that the directors are entitled, and indeed may be required in such circumstances, to take action which may have the effect of preventing the corporation from incurring new debt or disposing of assets in a manner which would prejudice the interests of its creditors. It is submitted that in such circumstances there is no unfair prejudice to the corporation’s creditors, and that such an action is consistent with the paramount duty owed to creditors as a whole. It is submitted that the decision in Re A Company, supra note 141 at 141, is strictly limited to the circumstances in which the corporation is effectively in control of its affairs, and that in such circumstances, the court should have jurisdiction to prevent the corporation from giving security for a loan. It is submitted that the decision in Re A Company, supra note 141 at 141, is not authority for the proposition that a court should not award damages for misconduct in relation to a security agreement. It is submitted that the decision in Re A Company, supra note 141 at 141, is not authority for the proposition that a court should not award damages for misconduct in relation to a security agreement.

161 AMCU Credit Union v. Olympic & York Developments Ltd. (1992), 7 B.L.R. (2d) 103 at 107.
163 e.g., that a secured creditor has improperly realized on security.
164 Re A Company [1987] Ch.D. 141. If the secured party is also effectively in control of the corporation (e.g., a sole director who has security for a loan) it may be that if the director improperly causes the corporation to acquiesce to improper enforcement, a breach of the oppression remedy could occur.
165Gower's Principles of Modern Company Law, 6th edn., supra note 149 at 603-5. R.H. Hyndman, Stransman & Voore, "Duties Owed by Directors to Creditors of Financially Distressed Corporations" (Canadian Insight Conferences, November 3, 1993).
an instance, to give paramount consideration to the interests of senior creditors and their wishes. Unsecured and junior secured creditors may, in essence, have no real economic stake. As the transition occurs from solvency to insolvency this means that related parties who are secured should not be prevented, by their related party status, from enforcing security. Although the issue is by no means uncontroversial, it may be that when insolvency is undoubted they can place their own interests as secured creditors first as they must place the interest of secured creditors first.\textsuperscript{166} There should be no obligation to jeopardise one’s secured position and to continue the business in an effort to create value for undersecured creditors or to allow judgment creditors to seize and sell assets.\textsuperscript{167} It is submitted that in the vast majority of cases these considerations will suggest that there is little opportunity for the oppression remedy to be called into play. To the extent the oppression remedy can be used by creditors it should, given the separate existence of the corporate debtor, usually be for corporate misconduct that is directed at an individual creditor and causes that creditor damages separate and apart from damage caused to the corporation. The remedy will normally sound in damages in the same way that a tort claim would, the extent of damages presumptively being the position that the creditor would have found itself in had the misconduct not occurred. It would seem that the principal advantage that the oppression remedy would offer over tort claims would be a possible wider ability to impose personal liability on officers and directors, especially if such officers or directors had personally benefited from the misconduct,\textsuperscript{168} and the possibility that conduct, although not normally tortious, might be held to have unfairly disregarded the interests of a creditor.\textsuperscript{169}

\begin{footnotesize}

\textsuperscript{167}In Levy-Russell v. Shieldings (1998), 165 D.L.R. (4th) 183 leave to appeal denied (1998) 41 B.L.R. 142 (Ont. Gen. Div.) the court suggested that an unsecured creditor has a reasonable expectation, capable of protection under the oppression remedy, that a secured party/shareholder will not conduct a corporation’s affairs in order to render the corporation judgment proof. It is not clear what the basis is for this statement. A corporation in order to access capital may well have to provide security over all its assets with the effect that there will be no practical recourse for a judgment creditor. In the absence of some specific holding out to a creditor as to the corporation’s debt structure, it is hard to see what legitimate complaint such a creditor could have if such a transaction is done with a view to the best interests of a corporation and, in a related party situation, is reasonable and fair.


\textsuperscript{169}e.g., Re Sidaplex Plastics Supplies Inc., ibid. Even here, however, this might require some direct holding out to the creditor so that the creditor’s loss is not merely derivative of the corporation’s loss.
\end{footnotesize}
V. Summary

The dozens of Canadian cases reported over the last 20 years dealing with creditor attempts to alter statutory priorities by appealing to equitable notions demonstrate that the law of secured transactions and insolvency is not immune to the tensions between certainty and fairness which exist elsewhere in the commercial law. Although hard worked trial courts have shown an understandable reluctance to permit equitable concepts to reorder statutory priorities, almost all instances have involved claims by consensual creditors who have failed to adequately protect themselves. Relatively little case law deals with creditors who may be involuntary. Further, there has been little or no considered analysis of these issues at the appellate level. Given the developments in commercial law over the last 20 years, it would be foolish to hazard a guess as to what appellate courts will do with such issues when they are finally squarely presented with them. There is no doubt, however, that there are significant policy considerations at play in the area of secured transactions which may suggest that the balance to be struck in this area of the law may differ from that which has emerged in other areas of commercial law.