

## TURNING LEAD INTO GOLD: THE UNCERTAIN ALCHEMY OF "ALL OBLIGATIONS" CLAUSES

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*This article examines the use of all obligation clauses in security agreements and their potential to transform an unsecured claim into a more valuable secured claim upon an assignment of the unsecured claim or the security agreement. The author addresses three arguments that have been levelled against the use of all obligations clauses: unfairness to the debtor, distortion of the pro rata sharing principle of bankruptcy law, and the disruption of the Personal Property Security Act priority regime. The author also examines two analogous transactions and explains why these do not create similar problems.*

*Cet article porte sur l'utilisation de tous les articles d'obligation dans les contrats de garantie et leur potentiel de transformer une créance ordinaire en une créance garantie d'une plus grande valeur au moment de la cession de la créance ordinaire ou du contrat de garantie. L'auteur soulève trois arguments contre le recours aux articles d'obligation, à savoir l'injustice envers le débiteur, la distorsion du principe de partage proportionnel de la loi sur la faillite et la rupture du régime prioritaire de la Loi sur les sûretés relatives aux biens personnels. L'auteur examine aussi deux transactions analogues et explique la raison pour laquelle elles ne créent pas de problèmes semblables.*

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## I. INTRODUCTION

The medieval alchemists, in their grand quest for the Philosopher's Stone, sought to discover a process for the transmutation of base metals. They thought that the admixture of even a tiny portion of the Stone with molten lead would cause the lead to catalyze into gold.<sup>1</sup> This article examines whether or not there might exist a modern day alchemy through which the less valuable claim of an unsecured creditor may be transmuted into the more valuable claim of a secured creditor without the need for any new act on the part of the debtor. The elixir that is said to produce this remarkable result is an appropriately drafted all obligations clause contained in a security agreement.

## II. FUTURE ADVANCES CLAUSES AND ALL OBLIGATIONS CLAUSES

It is common practice for lenders to provide a revolving credit facility to their business customers. This allows the debtor to draw on the credit in order to pay employees, landlords, and other creditors and, later, to pay it down when revenue is generated from the operation of the business. The arrangement is frequently referred to as an operating line of credit. In order to secure the line of credit, the lender will often take a security interest in the debtor's assets. The security agreement that secures the loan will typically contain a future advances clause which provides that the security interest also secures any further loans made by the lender on some future occasion.

Common law courts gave effect to future advances clauses in security agreements. However, problems arose for the secured party if an intervening security interest came into existence before the first secured party made the future advance. If the secured party did not know of an intervening interest, the secured party could "tack" the advance in priority to the intervening interest. But if the secured party knew of the intervening interest, the secured party could not tack the future advance. This principle was known as the rule in *Hopkinson v. Rolt*.<sup>2</sup>

There was, as well, a second rule of tacking. It arose when a legal mortgage was granted to secured party 1 (SP1), followed by an equitable mortgage granted to secured party 2 (SP2) and another equitable mortgage granted later to secured party 3 (SP3) who took without notice of SP2's interest. Under these circumstances SP1 would rank first in priority, followed by SP2 and then SP3. However, if SP3 bought out SP1's legal mortgage, SP3 could use SP1's legal interest as a *tabula in naufragio*, (the "plank in the shipwreck"), on which to tack SP3's advance so as to claim priority over SP2.<sup>3</sup>

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<sup>1</sup> John Read, *Prelude to Chemistry — An Outline of Alchemy. its Literature and Relationships* (London: G. Bell and Sons, 1936) at 118-26. In addition to its effect on metals, a Grand Elixir could be concocted by mixing a small quantity of the Stone with spirits of wine. Ingestion of this medicine by humans could cure all ills, restore youthfulness, and extend life. Although the quest for the Philosopher's Stone ultimately ended in failure, it established the foundation for the modern science of chemistry.

<sup>2</sup> (1861), 11 E.R. 829. The bar against the tacking of future advances applied even where the first secured party was under a contractual commitment to make the future advance. Instead, the first secured party was released from its commitment if the debtor granted an intervening security interest. See *West v. Williams*, [1899] 1 Ch. 132 (C.A.).

<sup>3</sup> *Bailey v. Barnes*, [1894] 1 Ch. 25. The *tabula in naufragio* doctrine was abolished in England by the *Law of Property Act, 1925*, 37 Statutes 72, s. 94.

Modern personal property security legislation<sup>4</sup> has sought to facilitate the use of secured credit. It does so by reversing the rule in *Hopkinson v. Rolt*. For the most part, a secured party now enjoys the same priority in respect of future advances as it does in respect of advances that were made before or contemporaneously with the execution of the security agreement.<sup>5</sup> It makes no difference whether the initial secured party knows of the existence of an intervening security interest. The secured party can claim full priority in relation to all future advances, and this is so even if the secured party was not under any commitment to make the advance.<sup>6</sup> An exception is made where a judgment enforcement creditor is involved. If the secured party knows of the judgment enforcement creditor's claim, the secured party will not be permitted to make a discretionary future advance in priority to the interest of the judgment enforcement creditor.<sup>7</sup> If the secured party is under a contractual obligation to make the advance, the outcome will differ by province. In Ontario, the secured party is permitted to make the advance in priority to the enforcement creditor.<sup>8</sup> In the other common law provinces and territories, the secured party is not entitled to claim priority over the enforcement creditor in respect of the advance. Instead, the secured party is released from the contractual obligation to make the advance.<sup>9</sup> The *tabula in naufragio* rule also has no application. As personal property security legislation no longer places any relevance on whether a security interest is legal or equitable, the entire basis for the rule has disappeared.

These legislative changes do not mean that a secured party will always be entitled to tack future advances to a security interest. A security interest is defined as an interest in personal property that secures payment or performance of an obligation. Just as it is necessary in the security agreement to describe the property that is given to the secured party as collateral, it is also necessary to describe the obligation or obligations that are to be secured by the collateral. The security agreement may cover a single, fixed obligation, or it may cover advances made in the future. Canadian personal property security legislation takes a permissive approach and provides that a security agreement may cover future advances.<sup>10</sup> This will allow a secured party to claim future extensions of credit as part of the obligation secured if they choose to include a future advances clause in their security agreement.

A future advances clause in a security agreement will typically provide that the security interest secures further extensions of credit. However, many security agreements do not limit

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<sup>4</sup> There are two different models of personal property security law currently in use in the common law jurisdictions in Canada. The first is the Ontario *Personal Property Security Act*, R.S.O. 1990, c. P.10 [OPPSA]. The second is the version used by most of the other jurisdictions that was based upon a model developed by the Canadian Conference on Personal Property Security Law (CCPPSL). In this article, the Alberta *Personal Property Security Act*, R.S.A. 2000, c. P-7 [APPSA] will be used as representative of the CCPPSL model Act.

<sup>5</sup> APPSA, *ibid.*, s. 34(5); OPPSA, *ibid.*, s. 30(3).

<sup>6</sup> APPSA, *ibid.*, s. 1(1)(u), definition of "future advance"; see also OPPSA, *ibid.*, s. 1(1). "future advance."

<sup>7</sup> In jurisdictions that do not provide for registration of writs in the personal property registry, the judgment enforcement creditor must seize the property before the provision comes into operation. See OPPSA, *ibid.*, s. 30(4). In jurisdictions that permit registration of writs or judgments in the registry, it is sufficient if the secured party knows of the existence of the writ or judgment. See APPSA, *ibid.*, s. 35(6).

<sup>8</sup> OPPSA, *ibid.*, s. 30(4)(b).

<sup>9</sup> APPSA, *supra* note 4, s. 14(2).

<sup>10</sup> APPSA, *ibid.*, s. 14(1); OPPSA, *supra* note 4, s. 13.

their application to future loan advances made by the secured party to the debtor, but are worded very broadly so as to cover all present or future obligations, indebtedness, and liability of the debtor to the secured party. These clauses, which will hereafter be referred to as “all obligations” clauses, are also referred to as “all moneys clauses” in Australia and the United Kingdom. The following is a typical example of this type of provision:

The Security Interest granted hereby secures payment and satisfaction of any and all obligations, indebtedness and liability of the Debtor to the Secured Party present or future, direct or indirect, absolute or contingent, matured or not, extended or renewed, wheresoever and howsoever incurred and whether it is from time to time reduced or entirely extinguished and thereafter incurred again and whether the Debtor be bound alone or with another and whether as principal or surety.<sup>11</sup>

All obligations clauses are not limited to future advances made by the secured party, but purport to cover other types of obligations as well.<sup>12</sup> Consider the case of a debtor who gives a bank a general security agreement containing an all obligations clause to secure an operating line of credit. Later, the bank mistakenly pays money to the debtor under circumstances in which it is entitled to recover the payment in a personal restitutionary action. Unless a court reads some limitation into the wording of the provision, the bank will assert that it is entitled to proceed against the debtor for the value of the mistaken payment as a secured party. The same would hold true where the obligation owed by the debtor takes the form of a guarantee of a debt of a third party or a liability to pay damages as a result of the commission of a tort or other wrong.<sup>13</sup>

The interpretation of future advances clauses and all obligations clauses has not given rise to very much case law in Canada. South of the border, one finds a much richer vein of jurisprudence. The use of future advances clauses and all obligations clauses often provokes judicial hostility. These provisions are often vilified as “dagnet clauses” or even as

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<sup>11</sup> See *Toronto Dominion Bank v. Del Grande* (1997), 12 P.P.S.A.C. (2d) 241 (Ont. C.A.) [*TD Bank*] for a discussion of a substantially similar provision. Banks and financial institutions commonly use a form of agreement referred to as a general security agreement which creates a security interest in all present and after-acquired personal property of the debtor. Most general security agreements contain some variation of an all obligations clause.

<sup>12</sup> Although the *PPSA* only refers to future advances (*i.e.*, extensions of credit from the secured party) and does not make any specific reference to security interests that secure other kinds obligations, there is little doubt that a security interest can cover such obligations since the very definition of a security interest is that it is an interest in personal property that secures payment or performance of an obligation and that the parties have the contractual freedom to specify the obligation that is secured by it. See *APPSA*, *supra* note 4, s. 1(1)(tt), definition of “security interest” and s. 9; *OPPSA*, *supra* note 4, s. 1(1), definition of “security interest” and s. 9(1).

<sup>13</sup> Courts sometimes construe these clauses narrowly so as only to apply to debts and not to other types of obligations (see *McGaveston v. NFMF Mortgages Ltd.*, [2002] N.Z.C.A. 312 [*McGaveston*], where the Court held that an all obligations clause does not extend to unliquidated claims for damages for breach of contract). In Australia, the cases are divided on whether such clauses cover monies owed by the spouse of a joint debtor who misappropriated funds from the secured party (see *Panbianco v. Bendigo Bank Limited & Anor.*, [1999] V.S.C. 50, where the Court found that the all obligations clause included such amounts. But see *contra*, *Re Bankrupt Estate of Murphy and Donnelly v. Commonwealth Bank of Australia Ltd.* (1996), 140 A.L.R. 46 [*Re Bankrupt Estate*], where the Court held that the clause did not cover such claims).

"anaconda mortgages."<sup>14</sup> The problem arises when the secured party attempts to bring beneath the umbrella of the security interest an obligation that is of a type that is not related to the type of loan or credit that occasioned the security interest. The case of *In re Johnson*<sup>15</sup> provides a good example of this approach. A bank had made a consumer loan to the debtor in order to permit the debtor to purchase an automobile. The bank later made a larger non-consumer loan to the debtor, but did not enter into a new security agreement at the time of this loan. The security agreement granted by the debtor in connection with the consumer loan provided that it covered "all other present or future, direct or contingent liabilities of Debtor to Secured Party, of any nature whatsoever."<sup>16</sup> The bank argued that this clause covered the subsequent loan. The Court held that for future indebtedness to be secured by reason of a future advance clause, the subsequent debt must "be of the same class as the primary obligation secured by the instrument and so related to it that the consent of the debtor to its inclusion may be inferred."<sup>17</sup> The Court applied the relatedness rule and held that, absent a clearly expressed intention to the contrary, the future advances clause only secured future indebtedness of a personal, family, or household nature and not future indebtedness of a business or commercial nature. Although a similar argument has been made in Australia, it appears that the courts have not adopted a general rule that an all obligations clause can only apply to debts of the same kind or character as the original debt.<sup>18</sup>

The relatedness rule in the United States has sometimes been applied to prevent the security agreement from securing any obligations that are not of the same class regardless of the wording of the security agreement.<sup>19</sup> When this happens the rule operates as a substantive rule of construction rather than as an interpretive principle designed to assist the court in determining the intention of the parties.<sup>20</sup> This view of the rule is fading, and courts are more likely simply to ask if the obligation to be secured was "reasonably within the contemplation of the parties to the mortgage at the time it was made."<sup>21</sup> Although future advances clauses and all obligations clauses will sometimes be construed strictly, the courts do not do so in the vast majority of the cases. Rather, the instances in which a court will apply a strict construction are limited to cases involving unsophisticated parties with unequal bargaining strength or cases where the clause is applied to unrelated, dissimilar, and often distant obligations.<sup>22</sup> This position is consistent with the sparse Canadian authority on point.<sup>23</sup>

<sup>14</sup> *Berger v. Fuller*, 21 S.W.2d. 419 at 421 (Sup. Ct. Ark. 1929): Justice Butler stated that they were aptly named "as by their broad and general terms they enwrap the unsuspecting debtor in the folds of indebtedness embraced and secured in the mortgage which he did not contemplate."

<sup>15</sup> 9 B.R. 713 (Bankr. MD Tenn. 1981).

<sup>16</sup> *Ibid.* at 714.

<sup>17</sup> *National Bank of Eastern Arkansas v. Blankenship*, 177 F.Supp. 667 at 673 (E.D. Ark. 1959).

<sup>18</sup> See Berna Collier, "'All Debts' Clauses in Commercial Contracts of Guarantee: Principles of Construction and Limitations on the Ambit of Clauses of this Nature" (1998) 24 Monash U.L.R. 7.

<sup>19</sup> See Bruce A. Campbell, "Contracts Jurisprudence and Article Nine of the Uniform Commercial Code: The Allowable Scope of Future Advance and All Obligations Clauses in Commercial Security Agreements" (1985-1986) 37 Hastings L.J. 1007 at 1040-55.

<sup>20</sup> See Jack B. Justice, "Secured Transactions — What Floats can be Sunk" (1978-79) 24 Villanova L. Rev. 867 at 896-911.

<sup>21</sup> *Kimbell Foods, Inc. v. Republic Nat. Bank*, 557 F.2d. 491 (5th Cir. 1977) at 495.

<sup>22</sup> See *Bank of Kansas v. Nelson Music Co., Inc.*, 949 F.2d. 321 (10th Cir. 1991).

<sup>23</sup> The leading authority is *TD Bank, supra* note 11, which held that a general security agreement that was given in connection with a business loan secured other non-business loans as well. The Court of Appeal for Ontario had regard to the clear language of the provision and was also influenced by the fact that

### III. ASSIGNMENT OF CLAIMS TO THE SECURED PARTY

Although the courts have regarded future advances clauses as a legitimate and necessary aspect of modern financing practice, judicial tolerance is pressed to the limit when a secured party attempts to secure more distant claims. In particular, judges have cast a jaundiced eye upon the secured party who buys up the claims of other unsecured claimants and then argues that the assigned claims have thereby been converted into secured claims by virtue of the wide language contained in an all obligations clause.

This controversy is illustrated in the following example. Suppose that a debtor (D) executes a security agreement in favour of a secured party (SP) to secure an operating line of credit. The security agreement covers all of the debtor's present and after-acquired personal property and contains an all obligations clause that testifies that the security interest covers any obligation that might exist between SP and D regardless of how or when it arises. SP properly registers a financing statement in the personal property registry. SP then advances \$10,000 to D. SP has obtained a perfected security interest in the collateral and thereby obtains priority over other claimants, including the unsecured claimants of D. As it turns out, D is deeply indebted to several unsecured creditors who have claims against D in excess of \$250,000. SP then enters into negotiations with the unsecured claimants who agree to assign their unsecured claims to SP. Once this is done, SP asserts that the all obligations clause in the security agreement is not limited to the \$10,000 advance made directly by SP to D, but also includes the assigned claims of \$250,000 obtained from the unsecured creditors.

Although there is little case law in Canada, the matter has attracted considerable judicial analysis in other countries. One of the leading cases is the Australian decision of *Re Clark's Refrigerated Transport Pty. Ltd.*<sup>24</sup> where Brooking J. commented upon the potential surprise to the debtor that would ensue if all obligations clauses were interpreted as encompassing assigned obligations:

It does seem strange that a man can lock up his counting-house and go home for the night, in the comfortable knowledge that his only secured creditor is his banker, to whom he owes a trifling sum secured by the usual boundless bank instrument, and unlock the door in the morning to find that, by virtue of assignments of the large but unsecured debts owed by him to his fellow merchants, and indeed to the butcher, the baker and the candlestick maker, all his unsecured debts have gone to feed his banker's insatiable security, so that every one of his debts is now secured.<sup>25</sup>

Justice Brooking held that the parties did not intend that the all obligations clause cover debts or liabilities assigned by a third person to the secured party.<sup>26</sup>

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the debtor was represented by a solicitor.

<sup>24</sup> (1981), [1982] V.R. 989.

<sup>25</sup> *Ibid.* at 995-96.

<sup>26</sup> The all obligations clause provided that the security interest secured all sums of money in which the debtor may now or hereafter become indebted or liable or contingently liable on any account whatever. The court held that the word "account" suggested that there must exist some transaction between the secured party and the debtor. The court also noted that the agreement provided that the secured party could call the loan if the collateral became insufficient, and that this would presumably apply where the

A court in the United Kingdom came to the same conclusion. In *Re Quest Cae Ltd.*, Nourse J. held that an all obligations clause that caught all "moneys and liabilities owing or incurred by the company to the lender on any account whatever"<sup>27</sup> only referred to dealings or transactions between the parties and, moreover, that it only referred to transactions of which records are opened and maintained by the lender.

The courts have not gone so far as to create a presumption that all obligations clauses should be construed strictly or read down simply because they are contained in a document that was drafted by a financial institution.<sup>28</sup> The approach most widely adopted by the courts has been to interpret an all obligations clause by reference to its context and commercial purpose. The courts will not generally construe it as covering a debt or obligation of a fundamentally different character unless the wording of the clause clearly contemplates its being included.<sup>29</sup> Justice Kirby characterized this process as a "struggle to resolve the competition between the typically very wide language of the clause and the natural inclination to confine any general contractual provision to the circumstances known to the parties at the time of their agreement or reasonably within their contemplation."<sup>30</sup>

In exceptional circumstances, courts may conclude that the factual context makes it clear that the parties intended that an all obligations clause should cover obligations assigned to the secured party even though the all obligations clause does not make specific reference to them. In *Town Oil (Receiver of) v. Bank of Montreal*,<sup>31</sup> the issue was whether a security agreement covered claims assigned to the secured party by a related company. Although the all obligations clause contained in the security agreement did not specifically cover assigned obligations, the British Columbia Court of Appeal held that the commercial context indicated that the parties to the agreement would have regarded the assigned debt to be within the category of debts which the security agreement was intended to cover. Husky Oil Operations Ltd. (HOO) had been given a security agreement in order to secure amounts owing under a distributorship agreement. It later sold its petroleum marketing assets to Husky Oil Ltd., but did not assign its security interest to it. Thereafter, the obligations incurred by the debtor were owed to Husky Oil Ltd., the successor company. Husky Oil Ltd. later assigned these obligations to HOO, and HOO claimed that they were secured by its security interest. The court held that the course of conduct of the parties, such as the amendment of the security agreement by the debtor so as to include two fuel trucks, demonstrated that the parties regarded the security agreement as a continuing business relationship, and that the purpose and object of the security agreement was to provide that the assets of the debtor were to secure the repayment of credit advanced by HOO or its successors.

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secured party was assigned debts of third parties. It was unlikely that the parties would have intended this result, and therefore this was taken to be further evidence that the all obligations clause was not intended to cover claims of third parties assigned to the secured party (*ibid.*).

<sup>27</sup> [1985] B.C.L.C. 266 at 267 (Ch. D.) [*Quest*]. See also *Kova Establishment v. Sasko Investments Ltd.*, [1998] 2 B.C.L.C. 83.

<sup>28</sup> See *Re Bankrupt Estate*, *supra* note 13 and *Smith v. Australia & New Zealand Banking Group Limited* (1996), N.S.W.Conv.R. 55774 [*Smith*].

<sup>29</sup> *McVeigh v. National Australia Bank Ltd.*, [2000] F.C.A. 187.

<sup>30</sup> *Smith*, *supra* note 28.

<sup>31</sup> [1988] B.C.J No. 826 (C.A.) (QL).

On the basis of these cases, one might reasonably predict that courts will not construe all obligations clauses as covering debts that are assigned to the secured party unless the clause specifically provides that such obligations are to be included or unless the commercial context suggests that this was intended by the parties.

The *Matter of E.A. Fretz Co. Inc.*<sup>32</sup> is the leading case on point in the United States. E.A. Fretz Company Inc. (Fretz) had given a security interest in its equipment and inventory to Revlon, Inc. (Revlon). The security agreement contained an all obligations clause which expressly provided that the security interest secured not only the obligations owed by the debtor to Revlon, but also any obligations owing to others which Revlon obtained by assignment or otherwise. Fretz later gave a security interest to Republic National Bank. Fretz eventually filed for bankruptcy. At the time of bankruptcy, Fretz was indebted to Revlon and was also indebted to two subsidiaries of Revlon. After the date of bankruptcy, the two Revlon subsidiaries assigned their claims to Revlon and Revlon claimed the status of a senior secured creditor in respect of these obligations.

Unfortunately, the court did not address the question of whether the all obligations clause in Revlon's security agreement covered the claims assigned by the subsidiaries.<sup>33</sup> Instead, the court viewed the matter as a registration issue and inquired into whether a financing statement could perfect a security interest in respect of "floating secured parties" (that is, the subsidiaries). This misconceived the issue, since it was Revlon and not its subsidiaries that was claiming the security interest. Nevertheless, the case is of interest since the Court expressed concern over the potential disruption of the bankruptcy regime:

If a senior secured party to a security agreement could, via post-bankruptcy assignment, secure and perfect under the umbrella of prior omnibus arrangements the claims of subsidiaries and strangers (general or unperfected secured creditors), the potential for inequality, and, indeed collusion or fraud, would be enormous. Sanctioning such transactions would truly create "strangers in paradise" violative of a cardinal principle of bankruptcy law. As has been pointed out: A prime objective of any scheme for dealing with financially embarrassed estates or persons is equitable distribution of assets to creditors.<sup>34</sup>

Commonwealth courts have not yet had to deal with this concern, since they have typically found that the drafting of the all obligations clause is not sufficient to cover claims assigned by third parties to the secured party. Nevertheless, they have been alert to this problem and have commented upon it. In *Quest*, Nourse J. stated:

[i]f the contention were to succeed and were not later to be frustrated on the grounds of public policy or the like, it would appear to be a licence to banks and other institutions holding all-moneys charges in similar form to go round buying up unsecured loan stock at a considerable discount and then to make substantial profits at the expense of the unsecured creditors.<sup>35</sup>

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<sup>32</sup> 565 F.2d 366 (5th Cir. 1978) [*Fretz*].

<sup>33</sup> For a critique of the reasoning in the decision, see Harry M. Flechtner, "Inflatable Liens and Like Phenomena: Converting Unsecured Obligations into Secured Debt under U.C.C. Article 9 and Bankruptcy Code" (1986-87) 72 Cornell L. Rev. 696 at 714-16.

<sup>34</sup> *Fretz*, *supra* note 32 at 374.

<sup>35</sup> *Supra* note 27 at 269.



#### IV. ASSIGNMENT OF THE SECURITY AGREEMENT TO ANOTHER PARTY

Instead of obtaining an assignment of the claims of others, the secured party may assign the security agreement to another party. The issue here is whether the assignee of a security agreement containing an appropriately drafted all obligations clause can obtain the benefit of the security interest in respect of any debts or obligations that are owed by the debtor to the assignee. This issue has arisen in two different contexts: first, when the security agreement is assigned to an unsecured creditor and second, when the security agreement is assigned to a junior secured party.

##### A. ASSIGNMENT OF THE SECURITY AGREEMENT TO AN UNSECURED CREDITOR

Where a security agreement with an all obligations clause is assigned to an unsecured claimant, the analysis is much the same as that employed by the courts where the secured party has bought up unsecured claims. Consider the following example. The secured party (SP) is given a security interest in all of the debtor's (D) present and after-acquired personal property. SP advances \$10,000 to D. SP later assigns its security agreement to a third party (TP). Prior to the assignment D is indebted to TP for \$25,000 pursuant to an unsecured loan. Following the assignment of the security agreement, TP makes a further loan of \$20,000 to D. Can TP claim the status of a secured creditor in respect of the \$25,000 loan that it made to D before obtaining an assignment of SP's security interest? And can TP claim the status of a secured party in respect of the subsequent loan of \$20,000 made by TP after obtaining an assignment of SP's security agreement?

Courts in the United States have been willing to permit an assignee of a security agreement containing an all obligations clause or future advance clause to claim the benefit of the security interest in respect of its subsequent loans to the debtor. By virtue of the assignment, the assignee steps into the shoes of the secured party and any further advances that are made to the debtor by the assignee are secured by the security interest.<sup>36</sup> This proposition should be equally uncontroversial in Canada. Neither the debtor nor any third party is in any way misled or prejudiced by such a transaction.

The more contentious issue concerns the claim by the assignee in respect of its previously unsecured obligations. Courts in the United Kingdom,<sup>37</sup> Australia,<sup>38</sup> New Zealand,<sup>39</sup> and the United States<sup>40</sup> have held that the particular drafting of the all obligations clause in the

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<sup>36</sup> *In re Cycle Products Distributing Co.*, 12 U.C.C. Rep. Serv. 2d 889 (Bankr. S.D. Ill. 1990); and *In re Robert B. Lee Enterprises, Inc.*, 980 F.2d. 606 (9th Cir. 1992).

<sup>37</sup> See *Sandhurst Holdings Ltd. v. Grosvenor Assets Ltd.*, [1985] B.C.L.C. 266; and *OGB Ltd. v. Allan*, [2001] B.P.I.R. 1111 [Allan].

<sup>38</sup> See *Katsikalis v. Deutsche Bank (Asia) AG*, [1988] 2 Qd. R. 641 [Katsikalis]; *Re Modular Design Group Pty Ltd.* (1994), 35 N.S.W.L.R. 96; and *Thomas v. Silvia* (1994), 14 A.C.S.R. 446.

<sup>39</sup> See *Kerr v. Ducey*, [1994] 1 N.Z.L.R. 577. See also *McGaveston*, *supra* note 13.

<sup>40</sup> See *Ex parte Chandler*, 477 So.2d 360 (Sup. Ct. Ala. 1985); and *Thorp Sales Corp. v. Dolese Bros. Co.* 453 F.Supp. 196 (D.C. Okl. 1978). In the latter case, a secured party assigned a security agreement covering five dump trucks (the first security agreement). The security agreement contained an all obligations clause. The assignee also obtained an assignment of a security agreement that had been given to a different secured party (the second security agreement). The assignee then claimed that the all obligations clause in the first agreement secured the obligation under the second security agreement.

security agreement was not sufficiently clear and unequivocal to produce this result. The courts expressed grave concern that a debtor would not normally anticipate that the clause would be used by an unsecured creditor to transform itself into a secured creditor simply by obtaining an assignment of the security agreement. Indeed, one judge referred to it as a “time-bomb.”<sup>41</sup>

Because the all obligations clause in each of these cases was found to be lacking, it was unnecessary for the courts to deal with the argument that a validation of the clause would undermine bankruptcy law. The problem was alluded to in *Allan*.<sup>42</sup> The Court questioned whether the operation of the provision could be open to challenge on the grounds of public policy, but commented that this was questionable as the foundational principle was that of freedom of contract and that, under insolvency law, restrictions on such freedom have been imposed almost entirely by statute. However, it noted that in exceptional cases the courts have invalidated contractual arrangements that had the effect of defeating the *pro rata* distribution rule of insolvency law.

## B. ASSIGNMENT OF THE SECURITY AGREEMENT TO A JUNIOR SECURED PARTY

A different set of considerations come into play where the secured party assigns the security agreement to a junior secured party. The issue here is whether the junior secured party can invoke the all obligations clause in the security agreement to promote its claim over that of higher ranked junior secured party. This is illustrated in the following example. Suppose that D gives SP1 a security interest in all of D’s present and after-acquired personal property to secure a loan of \$10,000. The security agreement provides that the security interest secures all present or future obligations incurred by the secured party. SP1 perfects its security interest by registration. D later gives a security interest in the same collateral to SP2, who perfects it by registration. Later still, D gives a security interest to SP3 to secure a loan of \$50,000. SP1 then assigns the security agreement to SP3. SP3 can undoubtedly claim priority over SP2 in relation to the \$10,000 obligation owed to SP1 and assigned to SP3. But can SP3 also claim priority over SP2 to the \$50,000 obligation that D owed to SP3? SP3 will claim that the all obligations clause in the security agreement assigned to it by SP1 covers this indebtedness, and therefore, SP2’s claim should be subordinated to its claim for \$50,000.

This issue has been considered on two occasions in Canada. In *Canamsucco Road House Food v. Lngas Ltd.*,<sup>43</sup> the Canadian Imperial Bank of Commerce (CIBC) held a senior ranking security interest, Canamuscco Road House Food (Canamuscco) held a second ranking security interest, and 936341 Ontario Inc. (936341) held a third ranking security interest in the assets of Lngas Ltd. 936341 paid off the amount owed to CIBC and obtained an assignment of its security interest. The Court held that although 936341 was entitled to priority in respect of CIBC’s obligation that had been paid out, it did not have priority in

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The case therefore involves both the issue of an assignment of a claim to the secured party and the issue of assignment of the security agreement to a third party.

<sup>41</sup> *Katsikalis*, *supra* note 38 at 650.

<sup>42</sup> *Supra* note 37.

<sup>43</sup> (1991), 2 P.P.S.A.C. (2d) 203 (Ont. Ct. J. (Gen. Div.)), reversed on other grounds (1997), 12 P.P.S.A.C. (2d) 227 (Ont. C.A.) [*Canamsucco*].

respect of the indebtedness owed by the debtor to 936341. Justice Mercier stated that "it would be inequitable to allow a third charge to take precedence over a second charge by obtaining an assignment of the first charge."<sup>44</sup>

The question also arose in *Near Horbay v. Great West Golf & Industrial*.<sup>45</sup> Toronto Dominion Bank (TD) was given a security agreement covering all property of Great West Golf & Industrial Inc. (Great West). TD properly registered its security interest and was therefore entitled to first priority. The security agreement provided that "this security shall be a continuing security for all sums of money owed by the Corporation to the Debenture Holder from time to time, whether pursuant to the provisions of this Debenture or otherwise."<sup>46</sup> Great West next gave a security interest in its assets to Newcourt Financial Ltd. (NFL). NFL's security interest provided that it secured "all debts, liabilities, and indebtedness present or future, direct or indirect, absolute or contingent, matured or not, whenever and howsoever incurred."<sup>47</sup> NFL registered its security interest and was therefore ranked second in priority.

Sometime later, 809359 Alberta Ltd. (809359) bought up unsecured claims of over \$575,000 from five unsecured lenders. 809359 then paid out a debt of approximately \$350,000 owing to TD and obtained an assignment of TD's security agreement. Great West owed more than \$848,000 to Club Car Inc. (CCI) for the supply of golf carts. CCI entered into a two step transaction with NFL under which it assigned its unsecured claim to NFL and then received back an assignment of NFL's claim together with NFL's security interest. Both claimants were therefore attempting to invoke an all obligations clause to add their own unsecured claims to the security interest that was assigned to them.

The Court held that both 809359 and CCI could only claim a security interest in respect of the original secured obligation which was associated with the security interest that was assigned to them. Neither party was entitled to add their own unsecured obligation to this amount. Justice Watson did not think that the language used in the all obligations clauses was sufficient to permit an assignee to bring other unsecured debt within the ambit of the security interest. However, he was not content merely to apply an interpretive approach, but went on suggest that this form of "debt-loading" would threaten the integrity of the *PPSA* priority system:

Viewing matters from the other direction seems instructive also. Other potential creditors in the business community and commercial economy knowing that, as a matter of law, earlier security instruments astutely drafted and assigned might permit assignees to later add later claims that might be completely unrelated to advances or the business up to the ceiling, if any, of the original security instrument, would only have, if anything, the ability to take very limited protective or cautionary steps. The predictability and reliability of the system, and the integrity of the priority structure designed by the *Personal Property Security Act*, would not be served by this, and yet the risk of stultifying credit would be real.<sup>48</sup>

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<sup>44</sup> *Ibid.* at 205.

<sup>45</sup> [2001] 3 W.W.R. 734 (Alta. Q.B.) [*Near Horbay*].

<sup>46</sup> *Ibid.* at 738.

<sup>47</sup> *Ibid.* at 739.

<sup>48</sup> *Ibid.* at 757.

Both *Canamsucco* and *Near Horbay* seem to suggest that the basis for the decision in each case was not merely a matter of interpretation of the particular all obligations clause, but that there may exist a substantive legal principle that will prevent parties from invoking the clause to alter priorities.<sup>49</sup>

## V. ASSESSING THE ARGUMENTS

The review of the cases that has been undertaken shows that there have been three fundamentally different types of arguments that have been deployed against the use of all obligations clauses to convert unsecured claims into secured claims. The first is concerned with the issue of unfairness to the debtor. The second is concerned with the destructive impact of this rule on the *pro rata* sharing principle of bankruptcy law. The third is concerned with the disruptive effect on the *PPSA* priority regime, and the consequent loss of predictability that this would cause. Each of these arguments appeal to a different set of values and objectives.

### A. THE UNFAIRNESS TO THE DEBTOR ARGUMENT

The majority of the cases have held that the particular language contained in the all obligations clause was not sufficiently wide to encompass assigned claims. This interpretive approach is primarily concerned with unfairness to the debtor. The parties to the contract have the contractual freedom to enter into whatever arrangements of private ordering that they choose. But it is also recognized that a contracting party may be taken by surprise by an unusual contract term. In such cases, courts have demanded that the contractual provision be set out in the clearest of language in order to give fair warning of it to the other party.

The interpretive approach has been applied consistently across several different jurisdictions. It is easy to understand why this is the case. Most debtors, including unsophisticated debtors, know the difference between secured credit and unsecured credit. They will appreciate that secured credit is typically priced cheaper than unsecured credit and that the secured party will have a superior set of enforcement remedies against the debtor in the event of default. An all obligations clause contained in a security agreement can turn these expectations on their head. Unsecured obligations can be converted into secured obligations simply by being assigned to the secured party or by having the security agreement assigned to the unsecured creditor. It is not too much to expect that the security agreement clearly and unequivocally makes clear it is to have this far-reaching effect.

The unfairness argument is subservient to the overarching principle of freedom of contract. Because the argument ultimately depends upon an exercise in contractual interpretation, it would not withstand a concerted effort by lawyers employed by financial institutions to draft an all obligations clause that would bring within its grasp every conceivable type of obligation. If this were thought to be undesirable, some other legal basis for challenging the

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<sup>49</sup> The judgment of Andrews C.J. in *Katsikalis*, *supra* note 38 also takes the view that there is a substantive legal principle that limits the efficacy of such assignments. However, the judgment of Thomas J. rejects this and concludes that the matters falls to be decided as a matter of construction (*ibid.*).

clause would need to be found. A court may attempt to invoke the doctrine of unconscionability if this clause were used in a consumer context. The widespread use of such clauses in a consumer context might also result in a legislative restriction of such terms through new consumer protection provisions.

Although the interpretive approach is primarily concerned with unfairness to the debtor, it has been frequently invoked by courts where the dispute was between the secured party and another claimant rather than between the secured party and the debtor. Although third parties may benefit from its application, the interpretive approach does not seek to protect their interests. The issue is conceived simply as a matter of discerning the contractual intention of the parties to the contract and whether the debtor at the time of signing the security agreement would have understood that it covered assigned obligations. In most cases, there is no real expectation that the third party will have read the security agreement or that it will have been misled by it in any way.<sup>50</sup>

## B. THE DISRUPTION OF BANKRUPTCY ARGUMENT

To understand the argument that all obligation clauses interfere with the *pro rata* sharing principle of bankruptcy law, it is necessary to outline briefly the salient features of bankruptcy law. Upon the occurrence of bankruptcy, claimants who have merely a personal right against the debtor are subject to an automatic stay of proceedings.<sup>51</sup> They are no longer permitted to pursue their claims through a civil action or to enforce their judgments through the provincial judgment enforcement system. The bankruptcy proceeding takes precedence over any judgment enforcement process unless it has been fully completed by payment to the creditor.<sup>52</sup> Upon bankruptcy, the claimant's personal right against the debtor is converted into a right to claim a dividend in the bankruptcy of the debtor.<sup>53</sup> As a result, the claimants lose their right to pursue individually their claims against the debtor and instead become subject to a collective proceeding in which a single agent, the trustee in bankruptcy, undertakes the liquidation on behalf of all the claimants who prove their claims in bankruptcy.<sup>54</sup>

Bankruptcy law reduces the total costs of collection by the creditors. It does so in two ways. First, it provides a summary method by which claims are validated and valued.<sup>55</sup> This reduces the costs associated with obtaining a judgment through a civil action. Second, it avoids the duplication of coercive collection measures that would otherwise be undertaken

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<sup>50</sup> Unsecured creditors will not generally know of the existence of the terms of the security agreement. Indeed, it is unlikely that they will even conduct a search of the registry before extending their credit (see Douglas G. Baird, "Notice Filing and the Problem of Ostensible Ownership" (1983) 12 J. Legal Stud. 53 at 60-61). Nor is it likely that competing secured creditors will rely upon the terms contained in the security agreement. Because a registration of a financing statement can cover more than one security agreement, there is an ever-present danger that the first secured party will subsequently enter into a new security agreement that contains different contractual terms. Any reliance by the competing secured party on the terms of an existing security agreement is therefore misplaced.

<sup>51</sup> *Bankruptcy and Insolvency Act*, R.S.C. 1985, c. B-3, s. 69.3. [*BIA*].

<sup>52</sup> *Ibid.*, s. 70(1).

<sup>53</sup> See Roy Goode, *Principles of Corporate Insolvency Law*, 2nd ed. (London: Sweet and Maxwell, 1997) at 57-58.

<sup>54</sup> *BIA*, *supra* note 51, s. 121(1).

<sup>55</sup> *Ibid.*, s. 135.

by the unsecured claimants. Bankruptcy law also ensures that the total amount recovered from a realization of the debtor's assets is greater than otherwise would be the case. It does so by restraining the destructive impulse of creditors to attempt to beat out other creditors by being the first to grab the assets.<sup>56</sup> This race of the swift will produce a lower total recovery than if the liquidation were carried out in a more orderly fashion. Once the liquidation is completed, bankruptcy law provides a *pro rata* sharing rule in respect of the proceeds resulting from the liquidation of the debtor's assets.<sup>57</sup> Some creditors may seek to pre-empt the *pro rata* sharing rule in bankruptcy by obtaining a transfer of assets shortly before the occurrence of the bankruptcy. Bankruptcy law inhibits this practice by permitting the trustee in bankruptcy to set aside these 11th hour transfers as fraudulent preferences.<sup>58</sup>

Bankruptcy law has little effect on third parties, including secured parties, who have proprietary claims to the debtor's assets. Bankruptcy law does not result in the confiscation of property belonging to others.<sup>59</sup> It is only the debtor's assets that vest in the trustee in bankruptcy.<sup>60</sup> So long as their security interests are properly registered or otherwise perfected, secured parties are, for the most part, entitled to pursue their secured creditor remedies outside of the bankruptcy system.<sup>61</sup>

The use of all obligations clauses in connection with assigned claims may be challenged by the debtor's trustee in bankruptcy. The trustee will argue that it weakens the *pro rata* sharing principle by permitting unsecured creditors to escape its application. This danger is illustrated in the following example. Suppose that SP is given a security interest in all of D's present and after-acquired personal property. The security agreement contains an all obligations clause. Unlike many of the all obligations clauses presently in use, this clause clearly and unequivocally provides that the security interest also extends to claims that are assigned by others to the secured party. SP makes a loan of \$10,000 to D. D also owes obligations to a number of unsecured claimants whose total claims against D amount to \$500,000. D goes bankrupt having assets worth only \$250,000 available for distribution amongst the unsecured claimants. In this example SP would obtain full recovery of its claim, while the unsecured creditors would recover 50 cents on the dollar.

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<sup>56</sup> See Thomas H. Jackson, *The Logic and Limits of Bankruptcy Law* (Cambridge: Harvard University Press, 1986) at 7-19. This incentive to be the first to grab assets is weaker in Canada because provincial non-bankruptcy law also provides a *pro rata* sharing principle amongst creditors. However, this *pro rata* sharing rule is considerably weaker than that employed in bankruptcy law. See e.g. *Civil Enforcement Act*, R.S.A. 2000, c. C-15, ss. 94-103. The provincial rule only applies to creditors who have already obtained a judgment, whereas the bankruptcy rule applies to all claimants whether or not they have proceeded to judgment. Although the impulse may be somewhat muted, creditors in Canada may still perceive there to be a benefit in enforcing their claims before other creditors are able to do so.

<sup>57</sup> *BIA*, *supra* note 51, s. 136(3). Certain claims listed as preferred claims in s. 136(1) must be satisfied first before the *pro rata* sharing principle is applied.

<sup>58</sup> *Ibid.*, ss. 95-96.

<sup>59</sup> See R. Goode, *supra* note 53 at 54-55.

<sup>60</sup> *BIA*, *supra* note 51, ss. 67(1)(c) and 71(2).

<sup>61</sup> Provincial law can validly modify property rights by imposing a registration requirement on security interests as well as other kinds of property interests and invalidating such interests as against the trustee in bankruptcy in the event of non-registration. See *APPSA*, *supra* note 4, s. 20(a); *OPPSA*, *supra* note 4, s. 20(1)(b). See also *Giffen (Re)*, [1998] 1 S.C.R. 91. However, if the security interest is properly perfected under provincial law, the trustee in bankruptcy has only a limited ability to interfere with the SP's exercise of its enforcement remedies.

But now suppose that SP obtains an assignment of the claims of some, but not all, of the unsecured creditors immediately before or after the bankruptcy. The claims that are assigned to SP will be covered by the all obligations clause contained in SP's security agreement; therefore, SP will assert that it is entitled to claim as a secured party in respect of these assigned obligations. Thus, if SP obtained an assignment of half of the total claims (\$250,000), SP could claim priority to the entire asset pool of the debtor. The unsecured creditors whose claims were not bought up by SP would receive nothing. The unsecured creditors who assigned their claims to SP would receive their agreed upon consideration from SP. Ordinarily, unsecured creditors would not be inclined to assign their claims for less than the amount that they would receive in bankruptcy (50 cents on the dollar) and, indeed, would wish to share some of the gains with SP. However, the dynamics of this situation are such that they may agree to a lesser amount. Each creditor will be worried that if they do not assign their claims to SP, some of the other creditors will do so. If this occurs, the non-assigning creditor will receive nothing. This places SP in a very powerful bargaining position. Although the unsecured creditors as a group would be better off if none of them assigned their claims, there is a considerable risk that some of these creditors will defect. The end result is that there is not simply a wealth redistribution amongst the unsecured creditors. The total amount available among the unsecured creditors as a class will be significantly less, since SP will have appropriated a substantial portion of the assets that would otherwise have been distributed amongst the unsecured creditors.

The use of all obligations clauses to convert unsecured claims into secured claims clearly has the potential to seriously undermine the *pro rata* sharing principle that is central to bankruptcy law. This logically leads us to the next question. Are there any legal devices or techniques that can be used by the trustee in bankruptcy to prevent the *pro rata* sharing principle from being circumvented in this fashion?

Bankruptcy law recognizes that an unsecured creditor may seek to escape the *pro rata* sharing principle of bankruptcy law by obtaining payments or transfers of property immediately before the occurrence of the bankruptcy. Unsecured creditors may also attempt to elevate their status to that of a secured creditor by obtaining a security interest shortly before the bankruptcy. Such transactions are frequently set aside by courts as fraudulent preferences under bankruptcy law or pursuant to provincial statute.<sup>62</sup> To set aside the transaction, the trustee in bankruptcy must establish that there occurred during the suspect period a transfer of property made by an insolvent person at a time when the debtor was insolvent that was intended to prefer one creditor over another.<sup>63</sup> There are two nearly insurmountable problems with any attempt to use fraudulent preference law in this context. The first has to do with the requirement under fraudulent preference law that there be a transfer by the debtor. The event that transforms the claim of the unsecured creditor into that

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<sup>62</sup> See e.g. *Burlingham v. Evjens Carpet Ltd.* (1983), 49 C.B.R. (N.S.) 220 (Sask. Q.B.); *Green Gables Manor Inc. (Re)*, (1998), 4 C.B.R. (4th) 273 (Ont. Ct. J. (Gen. Div.)); and *Canadian Imperial Bank of Commerce v. Grande Cache Motor Inn Ltd.* (1977), 4 Alta. L.R. (2d) 319 (S.C.T.D.).

<sup>63</sup> *BIA*, *supra* note 51, s. 95-6. The suspect period is three months prior to the date of the assignment or the petition for the receiving order. An extended period of one year is used if the preference was given to a related person. The definition of a related person is found in *BIA*, s. 4. In addition, to the provisions found in the *BIA*, the trustee in bankruptcy may also use provincial fraudulent preference statutes to set aside transactions. See *Robinson v. Countrywide Factors*, [1978] 1 S.C.R. 753.

of a secured creditor is either the assignment of the unsecured claim to a secured party or the assignment of the security agreement to an unsecured creditor. Neither of these transfers are ones that are undertaken by the debtor. There is no transfer by the debtor, since it is a creditor, and not the debtor, who enters into the transaction with the secured party. It might, perhaps, be argued that a conceptually new security interest arises every time a new advance is made or a new obligation is secured. There was a metaphysical debate in the United States on this issue. One school of thought promoted the multiple security interest theory in which each new advance created a distinct security interest.<sup>64</sup> Proponents of the other school advocated the unitary security interest theory in which a single security interest could expand so as to encompass additional obligations.<sup>65</sup> If one were to accept the multiple security interest theory, it would be possible to satisfy the requirement that the debtor transfer property during the suspect period since a new security interest would arise the moment that the all obligations clause was invoked.

However, even if the multiple security interest theory were to prevail, the trustee in bankruptcy would then encounter the second difficult hurdle. To succeed, the trustee must show that the debtor had the intent to prefer one creditor over another at the time of the transfer. As the debtor was not a party to the assignment that gives rise to the preference, it will not usually be possible to show that the debtor had the requisite intent to prefer.

A court might decide to tackle the issue by invalidating the all obligations clause on the grounds that it offends public policy to permit contracting parties to subvert the *pro rata* principle. This approach was taken in *British Eagle International Air Lines Ltd. v. Compagnie Nationale Air France*.<sup>66</sup> The House of Lords held that it would be contrary to public policy to permit an unsecured creditor to use a contractual right of set-off in order to give the creditor a greater right than the statutory right of set-off provided by insolvency law.

The problem with this approach is that it provides too crude an instrument to fix the problem at hand. All obligations clauses may be beneficial to the parties because they reduce the cost of restructuring the debtor's debt obligations.<sup>67</sup> Suppose that the parties wish to convert the unsecured debt obligations that have been issued into secured debt obligations. If the security agreement contains an ordinary future advances clause, the secured party could make a loan to the debtor on condition that the debtor use the proceeds of the loan to pay the unsecured creditors. Instead of this two step process, an appropriately drafted all obligations clause will allow the secured party to achieve the same result more cheaply by simply obtaining an assignment of these claims from the unsecured creditors. So long as neither of these transactions occur shortly before the bankruptcy at a time when the debtor is insolvent, there is no threat to the *pro rata* principle and no justification for invalidating the transaction.

The same holds true for an assignment of a security agreement to an unsecured creditor that converts the assignee's previously issued unsecured debt into secured debt. The

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<sup>64</sup> Peter F. Coogan, "Article 9 of the Uniform Commercial Code: Priorities Among Secured Creditors and the 'Floating Lien'" (1958-1959) 72 Harv. L. Rev. 838 at 867-68.

<sup>65</sup> Grant Gilmore, *Security Interests in Personal Property*, vol. 2 (Boston: Little Brown & Co., 1965) at 935-39.

<sup>66</sup> [1975] 1 W.L.R. 758 (H.L.).

<sup>67</sup> See Steven Walt, "The Case for Laundered Security Interests" (1996) 63 Tenn. L. Rev. 369 at 386-90.



institution of secured credit is given full recognition in bankruptcy. A creditor who has been issued unsecured debt may later obtain a security interest from the debtor. This transaction will only be impugned by the trustee in bankruptcy if it amounts to a fraudulent preference. Given these ground rules, there is no good reason for invalidating a transaction simply because the unsecured creditor has converted its claim to that of a secured creditor through the assignment of a security agreement containing an appropriately worded all obligations clause.

Instead of outright invalidation, a more selective approach is needed. As in the case of fraudulent preferences, a certain arbitrariness will be required. Canadian bankruptcy law provides that the suspect period is three months in the case of unrelated parties and one year in the case of related parties. A longer or shorter period might have been chosen, but ultimately it was a legislative policy choice that gave substance and definition to this rule. If broadly drafted all obligations clauses come to be used, a similar exercise in line-drawing will be required. This would be best accomplished by a legislative approach similar in design to the statutory rules that govern fraudulent preferences.

### C. THE DISRUPTION OF *PPSA* PRIORITIES ARGUMENT

The third argument is not about unfairness to the debtor or unfairness to other unsecured creditors. Instead, this argument looks to the position of other secured parties and considers whether the use of all obligations clauses to capture unsecured obligations will make it more difficult for a subordinate secured party to assess its priority position under the *PPSA*. Since one of the major objectives of modern personal property security legislation was to create a more predictable and commercially sensible set of priority rules, this would clearly be a significant concern if it turned out to be true. But is it in fact the case that the determination of priorities is rendered less certain – that it threatens the integrity of the priority regime?

In order to assess this claim, the following example will be used. Suppose that SP1 takes and perfects a security interest in D's assets. D later gives a security interest in the same asset to SP2, which is also properly perfected. Finally, D gives a competing security interest to SP3. At this point, the priority is SP1, SP2, and SP3. SP3 may attempt to negotiate with SP1 in order to obtain assignment of SP1's security agreement and then assert that the security interest captures SP3's obligation as well. If this occurs, the ranking of priorities change since SP3 will now have priority over SP2. Does this change in ranking make the *PPSA* priority regime less certain or predictable? At first glance it seems that SP2's position has been diluted by this transaction. SP2 may argue that it should be entitled to rely upon its second ranking position over SP3, but that it will not be able to do so if SP3 is able to obtain the benefit of SP1's priority position in respect of SP3's obligation.

There is, however, a serious flaw in SP2's argument. Once SP1 has registered a financing statement in the personal property registry and obtained first priority, SP2 should appreciate that it can be reduced to the status of an unsecured creditor by virtue of further advances made by SP1. This is so even if SP1's security interest does not contain a future advances clause or an all obligations clause as a financing statement can cover more than one security

agreement.<sup>68</sup> Therefore, even if SP1's initial security agreement does not cover future advances, SP1 will nevertheless obtain priority over SP2 if D later gives SP1 a second security agreement that covers such advances.<sup>69</sup> In assessing its priority position, SP2 must recognize that it will be subordinate to SP1 to the extent that SP1 chooses to make any further extension of credit to D. SP2 should not anticipate that its security interest will give it anything more than an unsecured claim and should price the loan accordingly.<sup>70</sup>

Furthermore, SP1 can confer priority upon SP3 even in the absence of a broadly drafted all obligations clause in SP1's security agreement. SP1 may make a further advance to D on condition that D use the money to pay out SP3's obligation. After this is done, SP1 could assign its security interest to SP3. The end result would be that SP3 would have priority over SP2 for the full value of the combined obligations.<sup>71</sup> If SP1 is able to do so indirectly through a two stage transaction, why should we not permit SP1 to do so through the use of a properly drafted all obligations clause?

There is one situation in which it might be said that the use of all obligations clauses renders the resolution of priority competitions less certain. This occurs where D has defaulted or where the parties are operating under the assumption that D's insolvency is imminent. If SP1's security agreement contains a broadly drafted all obligations clause, SP2 and SP3 may make competing offers to SP1 to obtain an assignment of SP1's security agreement. SP2 will know that if it does not do so, SP3 will obtain an assignment of it and thereby subordinate SP2's claim. Instead of simply obtaining the satisfaction of its claim from SP3, SP1 may demand that it obtain a portion of the increased value of SP3's claim. Indeed, rather than assigning its security interest to SP3, SP1 may instead propose that SP3 assign its claim to SP1.

These 11th hour or post-default manoeuvres are unproductive in that they lead to the investment of resources by the parties simply to wrest a larger slice of the pie from the grasp of other creditors. To curb these wasteful activities, it may be desirable to limit the effectiveness of all obligation clauses in these circumstances. A general invalidation of all obligations clauses would be an excessive response to the problem as it would inhibit the legitimate use of the clause as a means of reducing financing costs. Another possible response would be to strike down these last gasp attempts on the grounds that the party is

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<sup>68</sup> *APPSA*, *supra* note 4, s. 43(5); *OPPSA*, *supra* note 4, s. 45(3). The *OPPSA* takes a more limited approach in that it makes an exception where consumer goods are involved. In the case of consumer goods, the secured party must effect a new registration for each security agreement that is executed. In *Adelaide Capital Corp. v. Integrated Transportation Finance Inc.* (1994), 111 D.L.R. (4th) 493 (Ont. Ct. J. (Gen. Div.)), the Court held that a single registration can only cover separate security agreements if they are sufficiently linked. This has since been reversed by an amendment to the *OPPSA*, which provides that a financing statement may cover more than one security agreement whether or not the security interests are part of the same or related transactions. See *OPPSA*, *ibid.*, s. 45(4).

<sup>69</sup> *Royal Bank of Canada v. Agricultural Credit Corp. of Saskatchewan* (1994), 115 D.L.R. (4th) 569 (Sask. C.A.).

<sup>70</sup> Walt, *supra* note 67 at 396.

<sup>71</sup> One difference between these two types of transactions is that the consent of the debtor is needed in respect of the two step transaction. However, in the case of a widely drafted all obligations clause, the debtor will have consented in advance to this form of transaction.

violating a duty to act in good faith and in a commercially reasonable manner.<sup>72</sup> However, to apply a discriminative approach a court must be able to accurately distinguish instances of opportunistic behaviour from instances where the transaction is contemplated as a legitimate refinancing procedure that will permit D to avoid insolvency. If this distinction is not easily drawn, then a rule which uses this as a criteria will simply result in increased litigation costs and a greater possibility of judicial error.

## VI. ANALOGOUS TRANSACTIONS

There are two other transactions that may appear to raise similar questions. One involves subrogation, the other involves a purported assignment of a financing statement. However, upon a proper analysis of the law, it becomes apparent that the same problems associated with the use of all obligation clauses do not arise in these cases.

### A. SUBROGATION

Subrogation is a special type of restitutionary remedy. It involves the substitution of one party for another so that the party who is substituted may exercise the rights of the other party in respect of a claim.<sup>73</sup> The right to subrogation arises in a number of established categories.<sup>74</sup> One such category is where a third party at the request of a debtor pays off a security interest with a view to obtaining a first ranking security interest on the property. In the absence of evidence of intention to the contrary, the third party is entitled in equity to assert the security interest of the first secured party.<sup>75</sup> The *PPSA* expressly preserves common law and equitable principles to the extent that they do not conflict with the Act, and courts in Ontario and the United States have indicated that the remedy continues to be available in modernized personal property security regimes.<sup>76</sup>

Although one might be tempted to equate subrogation with an assignment that comes about through the operation of law rather than through the agreement of the parties, this comparison is misleading. A party who is subrogated to the rights of a senior secured party does not enjoy precisely the same rights as a party who obtains an assignment of the senior secured party's security agreement. In the case of subrogation, the creditor has the right to assert rights under the security interest only to the extent of the amount that was paid out to the senior secured party.<sup>77</sup> This point is illustrated in the following scenario. D grants

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<sup>72</sup> The *PPSAs* in all of the provinces except Ontario expressly impose such a duty on all the parties (see *APPSA*, *supra* note 4, s. 66(2)). A similar non-statutory obligation might be created by the courts in Ontario.

<sup>73</sup> See generally, Charles Mitchell, *The Law of Subrogation* (Oxford: Clarendon Press, 1994).

<sup>74</sup> The question whether the remedy is one of general application as a response to unjust enrichment or one that is available only in respect of a certain well-defined instances is a controversial one. However, it need not detain us here as the availability of subrogation in this particular context is clearly established.

<sup>75</sup> See *Coupland Acceptance Ltd. v. Walsh*, [1954] S.C.R. 90; *Gordon v. Snelgrove*, [1932] 2 D.L.R. 300 (Ont. S.C.); *Hayward Lumber Co. v. McEachern*, [1931] 3 W.W.R. 658 (Alta. S.C.T.D.); and *Crosbie-Hill v. Sayer*, [1908] 1 Ch. 866.

<sup>76</sup> See *N'Amerix Logistix Inc. (Re)* (2001), 57 O.R. (3d) 248 (Sup. Ct.); *French Lumber Co. v. Commercial Realty & Finance Co.*, 195 N.E.2d 507 (Super. Ct. Mass. 1964); *Kaplan v. Walker*, 395 A.2d 897 (Super. Ct. A.D. N.J. 1978); and *Rinn v. First Union National Bank of Maryland*, 25 U.C.C. Rep.Serv.2d 1057 (D. Md. 1995).

<sup>77</sup> See *Orakpo v. Manson Investments Ltd.*, [1977] 1 W.L.R. 347 at 361.

competing security interest in the same collateral to secured party 1 (SP1), secured party 2 (SP2), and secured party (SP3). SP1 is the first to register, followed by SP2 and then SP3. SP1's security agreement contains an all obligations clause, and the amount presently owing by D is \$50,000. SP2 pays out SP1's obligation in the expectation that it will thereby become the senior secured party. Thereafter, SP2 makes further advances of \$100,000 pursuant to its security agreement. It later transpires that there is a fatal defect in SP2's registration such that SP2 is subordinate to SP3. SP2 has the right to be subrogated to SP1's claim. This gives SP2 the right to claim priority in respect of the \$50,000 that it paid to SP1. But SP2 will not have priority over SP3 in respect of the \$100,000 that it advanced after paying out SP1's obligation.

Subrogation revives the security interest of SP1 that ordinarily would have come to an end by the payment of the obligation secured. SP2 is subrogated to SP1's claim only to the amount that SP2 paid to SP1. However, SP2 does not thereby obtain an assignment of the security interest and is therefore unable to invoke an all obligations clause contained in SP1's security interest to cover other obligations owing by the debtor to SP2. As a result, none of the questions concerning the use or abuse of such clauses will come into play in this scenario.

## B. "ASSIGNMENT" OF THE FINANCING STATEMENT

A few cases in the United States have dealt with a purported assignment of the financing statement, rather than an assignment of the secured party's security interest. Here the claimant does not base its claim on a security interest that was assigned to it, but on its own security interest that was granted to it by the debtor. The claimant instead argues that it has obtained through transfer a financing statement of another person and that this gives it the right to treat the registration as its own. The claimant then asserts that its own security interest is entitled to priority on the basis of its having the earlier registration. The validity of this practice has been sharply debated in the United States. In one decision, the Court held that a secured party could assign its financing statement to another party without the need to assign the underlying security interest.<sup>78</sup> The assignee of the financing statement was then permitted to use this financing statement to give it priority in respect of its own security interest with the debtor. Another case came to the opposite conclusion and held that a purported assignment of a financing statement is ineffective without an assignment of the underlying security agreement.<sup>79</sup>

Some United States commentators have argued that a secured party should be able to assign its financing statement and thereby sell its place in line.<sup>80</sup> It is highly doubtful whether this position will be accepted in Canada. It is possible in Canada to register a financing statement against the name of a person without the consent of the person named as a debtor

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<sup>78</sup> *In re Camp Town, Inc.* 32 U.C.C. Rep.Serv.2d. 598 (Bankr.D.N.M. 1996).

<sup>79</sup> *In re Leisure Time Sports, Inc.* 29 U.C.C.Rep.Serv.2d. 559 (9th Cir. BAP, 1996).

<sup>80</sup> See Spencer Neth, "The First to File Priority in Article 9: Can You Sell Your Place in Line?" (1998), 31 U.C.C.L.J. 64; and Steven Walt, "Revisiting Neth's *The First to File Priority in Article 9: Can You Sell Your Place in Line?* And Shanker's *Response*" (1998), 31 U.C.C.L.J. 217. For an opposing view, see Morris Shanker, "A Response to *The First to File Priority in Article 9: Can You Sell Your Place in Line?*" (1998), 31 U.C.C.L.J. 82.

in the registration.<sup>81</sup> The ability to sell a priority position based upon such a registration would be a startling proposition. Although the Canadian authorities<sup>82</sup> dealt with the effect of an assignment of the security agreement rather than an assignment of the financing statement, there would have been no need to consider the operation of the all obligation clauses if the assignee was permitted to claim priority on the basis of the assignor's financing statement.

Quite apart from the case law, there is no mechanism contained in the *PPSA* for an assignment of a financing statement. The statute provides for the assignment of a security interest, not an assignment of a financing statement. Indeed, a financing statement is not an agreement at all, and to speak of an assignment of it makes little sense. Upon an assignment of a security interest, the assignee may register a financing change statement that discloses the name of the assignee.<sup>83</sup> This simply adds the name of the assignee as a secured party as of the time when the financing change statement is registered.<sup>84</sup> It does not operate as a transfer of the registration from one party to the other.

Unless the courts in Canada embark upon an unexpected and radical change in direction, there is little prospect that they will attempt to use a theory based upon the assignment of a financing statement as opposed to one based upon the assignment of the underlying security interest in resolving priority competitions.

## VII. CONCLUSION

As it turns out, the transmutation of an unsecured claim into a secured claim is perhaps not as remarkable as it first appears. A security interest is an interest in property that secures payment or performance of an obligation. It is up to the parties to specify precisely which obligations are to be secured by the security interest. Often the security agreement is drafted very widely so as to encompass all present or future obligations that may be owed by the debtor to the secured party. When unsecured claims owed by third parties to the debtor are assigned to the secured party, the secured party may seek to invoke such an all obligations clause and claim that they are properly considered to be obligations that are secured by the security interest. Similarly, if the secured party assigns its security interest to another, the assignee may argue that unsecured obligations previously owed by the debtor to the assignee are caught by the all obligations clause and secured by the security interest.

Three arguments have been levelled against the use of all obligations clauses. The first is concerned with the unfairness to the debtor. The courts are concerned that the debtor will not realize that the all obligations clause extends this far and will be taken by surprise. Courts have overwhelmingly embraced this approach. Across the Commonwealth and in the United States, they have applied an interpretive approach. In the absence of clear and unequivocal language, an all obligations clause will only apply to additional obligations that were contracted as between the original parties to the security agreement.

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<sup>81</sup> The person named as debtor can require the registering party to discharge the registration if the registration is unwarranted. See *APPSA*, *supra* note 4, s. 50; *OPPSA*, *supra* note 4, s. 56.

<sup>82</sup> *Canamsucco*, *supra* note 43; *Near Horbay*, *supra* note 45.

<sup>83</sup> *APPSA*, *supra* note 4, s. 45(1); *OPPSA*, *supra* note 4, s. 47(1).

<sup>84</sup> *APPSA*, *ibid.*, s. 45(5); *OPPSA*, *ibid.*, s. 47(3).

It may be that secured parties are content with the status quo. They may choose to retain their old and familiar security agreements with all obligations clauses that do not specifically cover assigned third party claims or that do not expressly permit an assignee of the security agreement to add the assignee's own debt to the obligation secured. If this happens there will be no controversy. The courts will simply apply the interpretive approach. Difficulties will only arise if the commercial lawyers who draft security agreements on behalf of their clients refashion the all obligations clauses so that they unequivocally apply to assigned claims. If this happens, it will become necessary to examine the other two other arguments that have been made against the use of all obligations clauses. One is concerned with the effect of such clauses on the *pro rata* sharing principle of bankruptcy law. The other is concerned with the loss of certainty and predictability of the *PPSA* priority rules.

The use of all obligations clauses undoubtedly have the potential to distort the *pro rata* sharing principle of bankruptcy law. The problematic case is where a secured party buys up the unsecured claims of an insolvent debtor at a discounted price and then immediately claims full secured party status in relation to them by virtue of an all obligations clause in the security agreement. The conversion of these claims benefits the secured party at the expense of the unsecured creditors. Fraudulent conveyance and preference laws provide a mechanism through which value reducing transfers made on the eve of insolvency can be struck down. This body of law does not provide an effective response to the problem. Its focus on the intent of the debtor and the requirement of a transfer by the debtor prevents it from being used to remedy the abusive employment of all obligations clauses.

The final argument is that all obligation clauses disrupt *PPSA* priorities. This claim is more controversial. The *PPSA* permits a single registration to cover more than security agreement. A secured party who has registered second in time must accept the fact that the senior secured party can refinance or enter into new security arrangements with the debtor and that these arrangements will be entitled to priority. There are several different means through which the refinancing can occur. The senior secured party may make additional advances to the debtor which are then used to pay out unsecured creditors. Alternatively, the senior secured party may obtain an assignment of the claims of the unsecured creditors and claim secured party status through the operation of an appropriately drafted all obligations clause in the security agreement or it can assign its security interest to a third party. Once the senior secured party has staked its claim by registering a financing statement, later secured creditors must recognize that the first secured party has the power to undercut their positions by making further advances. This being the case, there is no reason why the senior secured party should not also be permitted to restructure the debtor's debt obligations by buying up unsecured claims or by assigning its security interest to another party. The use of an obligations clause in this context is commercially reasonable and legitimate, and there is no reason in principle to limit its operation.

The use of all obligation clauses is more objectionable when the assignment occurs at a time when the debtor has ceased to function as a viable economic entity. A third ranked secured party may attempt to obtain an assignment from a first ranked secured party in order to leap-frog over a second ranked secured party. Understandably, courts are less inclined to give their blessing to the use of all obligation clauses in these circumstances.

It is quite possible that the courts, in an attempt to control the abuse of all obligations clauses, will adopt a substantive rule of law that invalidates their use in connection with assigned claims or assigned security interests. The problem with this approach is that it is overly broad. All obligation clauses do not threaten the *pro rata* sharing principle so long as the assignment occurs when the debtor is solvent. Nor do they undermine *PPSA* priorities when used in a legitimate debt restructuring transaction. The challenge, if redrafted forms of all obligation clauses are written and deployed, will be to develop a means of validating their legitimate use while controlling their abuse.

