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SUBORDINATION AGREEMENTS, BANKRUPTCY AND THE PPSA

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I. INTRODUCTION

Working out a satisfactory legal analysis of subordination agreements is a slippery business. A subordination agreement involves a contractual modification of the legal rules that ordinarily govern the order of repayment or distribution to creditors or the priority ranking of their security interests. Because these are matters that the parties are free to negotiate, it becomes a fool's errand to attempt to make universal statements about the legal nature of these arrangements.[1] While I will argue that the contractual language that is typically used in Canada to subordinate or postpone one security interest to another does not involve an assignment of the secured creditor's claim to the other creditor, this does not mean that the parties cannot through the inclusion of appropriate contractual language create such an assignment. The resolution of the matter will, therefore, ultimately depend upon the construction of the particular contract in each case. Problems are compounded because many subordination agreements fail to clearly specify the type of legal rights that are being created.

In addition to these interpretive challenges, there are also substantive difficulties in identifying the applicable legal rules and principles. Canadian litigation on subordination agreements has not yet produced a definitive Canadian case law that thoroughly explores the essential concepts. Although judicial decisions from England and the United States are valuable in the absence of Canadian case law on point, they must be carefully scrutinized to determine if differences in the underlying insolvency principles or the legal precedents that are used by the parties render the decisions inapplicable in a Canadian context. A further source of complexity arises from a lack of uniformity in the relevant provisions of the provincial personal property statutes.

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1. G. Gilmore, *Security Interests in Personal Property*, vol. 2 (Boston, Little, Brown and Co., 1965), at p. 986, observes that "[s]ubordination agreements can be as various as the wit and imagination of the draftsmen permit."

Despite these limitations, it is possible to devise a workable framework for analyzing subordination agreements and the legal issues associated with their use. I will begin by providing several examples that illustrate situations in which subordination agreements are commonly used, in order to provide a context for the discussion that follows. I will then introduce a number of ways of categorizing subordination agreements and establish the fundamental distinction between debt subordinations and security interest subordinations — a distinction that will be used to organize the ensuing discussion. I will next examine the types of contractual arrangements that can be employed in debt subordinations and will identify and attempt to resolve several critical issues concerning their legal nature, with a particular emphasis on the interplay of bankruptcy law[2] and personal property security law on their operation. Following this, I will apply the same methodology in examining security interest subordinations.

II. EXAMPLES OF SUBORDINATION AGREEMENTS

The following cases illustrate situations where contracting parties commonly enter into subordination agreements with one another.

Case 1

The major shareholders of a closely held corporation, who also serve as directors, have each made a shareholder loan to the corporation. The corporation subsequently wishes to borrow money from a bank. The bank agrees to lend the money, but requires that each director execute a postponement agreement under which the director agrees that he or she will not be entitled to obtain payment from the corporation until the claim of the bank is fully satisfied.

2. There are also a number of issues concerning classification and voting in respect of subordination agreements in restructuring proceedings; however, this raises a different set of issues and analyses and therefore, lies outside the scope of this paper. See R. Wood, ***Bankruptcy and Insolvency Law*** (Toronto, Irwin Law, 2009), at pp. 412-413 and 431-432. For the position in the United States, see J.L. Lopes, "Contractual Subordinations and Bankruptcy" (1980), 97 Banking L.J. 204, at pp. 215-217 and pp. 224-230; D. Kravitz, "The Outer Fringes of Chapter 11: Nonconsenting Senior Lenders' Rights Under Subordination Agreements in Bankruptcy" (1992), 91 Mich. Law Rev. 281.

Case 2

A lender agrees to provide mezzanine financing[3] to a corporate borrower. An agreement is entered into between the mezzanine lender and other lenders, under which the mezzanine lender agrees to subordinate its claim to the claims of the other lenders in the event of insolvency of the debtor.

Case 3

A corporation issues high-yield notes or debentures that provide that the holder is not entitled to payment until designated senior creditors are fully paid. Here, the subordination provision is contained in the instrument issued by the debtor that creates the debt.[4]

Case 4

A debtor grants to a lender a security interest in all its present and after-acquired personal property to secure a loan. The security agreement negotiated between the debtor and the secured party contains a negative covenant that prohibits the debtor from encumbering the collateral, but further provides that the debtor is permitted to grant purchase-money security interests to other creditors in priority to the security interest given to the lender.

Case 5

A debtor grants a security interest in all its present and after-acquired personal property to a secured party (SP1) to secure a loan to finance Project A. The debtor wishes to borrow from another secured party (SP2) to finance Project B, but SP2 is hesitant to lend because SP1 has a financing statement that covers all the debtor's present and after-acquired personal property. SP1 enters into an intercreditor agreement[5] with SP2, under which SP1 agrees to subordinate its security interest in respect of all assets associated with project B.

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3. Mezzanine financing has been described as lying between debt and equity. The junior lender will usually insist on a higher rate of interest and will often demand the issuance of warrants or conversion features that permit it to acquire a share ownership in the corporation to compensate for the increased risk to the junior lender on default. See P. Wood, *Project Finance, Securitisations, Subordinated Debt*, 2nd ed. (London, Sweet & Maxwell, 2007), pp. 178-79; A.J.F. Kent, "Layered Financing: Subordination and Other Legal Puzzles" (1991), 8 Nat. Insol. Rev. 36.
4. See, for example, "Revised Model Simplified Indenture" (2000), 55 Bus. Law. 1115 at p. 1158.
5. An intercreditor agreement is an agreement concluded between two or more of the creditors who have competing security interests in the same collateral. It can be used to modify the priority ranking that would otherwise apply, as in Case 5;

Case 6

A supplier (SP1) retains a purchase-money security interest on inventory that it supplies to a debtor on credit terms. The debtor later grants a security interest in all its present and after-acquired personal property to a secured party (SP2) to secure an operating line of credit. In order to minimize the risk of future litigation over the proceeds of inventory,[6] SP1 and SP2 enter into an intercreditor agreement, under which it is agreed that SP1 will have priority over any cheques, trade-ins or other proceeds in its possession and that SP2 will have priority in respect of any amounts deposited into the operating account.

III. CATEGORIES OF SUBORDINATION AGREEMENTS

1. Debt Subordination and Security Interest Subordination

The most fundamental distinction is the division between debt subordination and security interest subordination.[7] Cases 1 to 3 involve debt subordination agreements. In these cases, the junior creditor agrees to subordinate its claim against the debtor until the claim of the senior creditor is satisfied. Cases 4 to 6 involve security interest subordination agreements. In these examples, it is not

or it can be used to provide certainty where the priority rules may be unclear, as in Case 6. Less commonly, an intercreditor agreement can be used to modify the enforcement of the secured parties' remedies rather than the priority ranking of their security interests. See A. Manzer and H. Ruda, *Asset Based Lending in Canada: Canadian Primer on Asset Based Financing Based on Asset Based Financing: A Transactional Guide* (Markham, LexisNexis Canada, 2008), p. 283. Sometimes the term is used to denote subordination agreements in which the reciprocal subordinations are granted in different segments of collateral, as opposed to one-way subordinations in which a secured party subordinates its security interest to another secured party. See P.H. Weil, *Asset-Based Lending: An Introductory Guide to Secured Financing* (New York, Practising Law Institute, 1989), p. 507.

6. There is presently some uncertainty under the PPSA on this matter. Although the priority afforded to the inventory financer can be asserted in respect of any proceeds of the inventory, it is unclear if SP2 can assert a right of set-off in respect of amounts deposited into the operating account. See R.C.C. Cuming, C. Walsh and R.J. Wood, *Personal Property Security Law* (Toronto, Irwin Law, 2005), pp. 562-564. In this instance, the purpose of the subordination agreement is not so much to induce the extension of credit by SP2, but to provide greater certainty as to the respective rights of the parties and to reduce post-default litigation expenses.

7. In the United States, security interest subordination is commonly referred to as lien subordination. See, *e.g.*, D.G. Carlson, "A Theory of Contractual Debt Subordination and Lien Priority" (1985), 38 Vand. Law Rev. 975 at p. 1019. This terminology is not used in Canada, since liens are generally understood to refer to certain kinds of non-consensual security interests.

payment of the debt that is being postponed; rather, the subordinating creditor agrees that its security interest should be ranked behind the security interest of some other creditor.

The difference between debt subordination and security interest subordination is illustrated in the following example: A secured party (SP1) agrees to subordinate its security interest in favour of a security interest held by another secured party (SP2). By doing so, SP1 is subordinating the ranking of its security interest rather than payment of its debt.[8] Where the collateral is not sufficient to satisfy SP2's claim, SP1 and SP2 will both be entitled to enforce their claims against the debtor. In the event that the debtor goes into bankruptcy, they are both entitled to prove their claims and share pro rata in respect of a bankruptcy distribution. By way of contrast, a creditor who has entered into a debt subordination agreement is unable to recover on its claim until the claims of the other creditors are fully satisfied.

In order to underline the division between debt subordination agreements, a different terminology will be used to describe the parties to these two types of subordination agreements. Where a debt subordination agreement is involved, the subordinating party will be referred to as the "junior creditor" and the party who obtains the benefit of this subordination will be referred to as the "senior creditor." This accords with the terminology employed in many debt subordination agreements.[9] Where a security interest subordination agreement is used, the subordinating party will be referred to as the "subordinating creditor" and the party who obtains the benefit of this subordination will be referred to as the "benefiting creditor."

In some cases, a subordination agreement may provide for both types of subordinations. A junior creditor that subordinates its debt in favour of a senior creditor may also be required to subordinate any security interest that it holds in favour of the senior creditor. This is done in order to avoid a situation where the junior creditor has promised not to enforce its claim until the claim of the senior creditor is satisfied, yet the senior creditor finds itself unable to enforce its claim because the debtor's property is subject to a security interest held by the junior creditor.[10]

8. Many security interest subordination agreements also contain standstill provisions that restrict the ability of the subordinated creditor to enforce its security interest or otherwise interfere with the exercise of the enforcement remedies of the benefiting creditor. See Weil, *supra*, footnote 5, at pp. 503-504; Manzer and Ruda, *supra*, footnote 5, at p. 296.
9. See P. Wood, *supra*, footnote 3, at p. 177.
10. Weil, *supra*, footnote 5, at 499. Manzer and Ruda, *supra*, footnote 5, at p. 289,

2. Complete Subordination and Inchoate Subordination

Another division focuses on the time when the subordination takes effect. In some instances, the agreement will take effect immediately, so that no payment may be made to the junior creditor until the claim of the senior creditor is satisfied. This is referred to as an "absolute"[11] or "complete"[12] subordination, and is more likely to be found in debt subordination agreements granted by a corporate insider (as in Case 1).[13] This ensures that the loan of the insider is locked-in until the debt of the senior creditor is repaid.

A complete subordination is rarely appropriate where the subordination is in favour of an outside investor (as in Cases 2 and 3). The investor expects to receive regularly scheduled repayments on the loan as long as the debtor is not in financial distress. The subordination provisions associated with these agreements will, therefore, provide that the subordination comes into play only upon a triggering event such as a loan default or the commencement of insolvency proceedings. These types of subordinations are sometimes referred to as "inchoate",[14] "springing"[15] or "contingent",[16] in order to denote the delay in their effectiveness. As there is a danger to the senior creditor that the debt subordination will be undermined by pre-payments or other extraordinary payments made before the triggering event is activated, the subordination agreement will usually place limits on the payments that can be made to the subordinating creditor prior to the triggering event.[17]

The distinction between complete and inchoate subordinations is not usually used in respect of security interest subordinations. The subordination of the security interest is usually immediate; however, as it is only the ranking of the security interest and not payment of the underlying claim that is subordinated, payments can ordinarily be made to the subordinating creditor, despite the fact that the claim of the other creditor has not been fully satisfied.

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state that a debt subordination of a secured debt inherently subordinates the junior creditor's security interest as well.

11. B. MacDougall, "Subordination Agreements" (1994), 32 Osgoode Hall Law J. 225 at p. 229.
12. D.M. Calligar, "Subordination Agreements" (1961), 70 Yale L.J. 376 at p. 378.
13. J.R. Powell, "Rethinking Subordinated Debt", [1993] L.M.C.L.Q. 357 at pp. 358-359.
14. Calligar, *supra*, footnote 12, at p. 378.
15. P. Wood, *supra*, footnote 3, at p. 177.
16. MacDougall, *supra*, footnote 11, at p. 229.
17. These are often referred to as "payment blocks." See P. Wood, *supra*, footnote 3, at pp. 217-221; Weil, *supra*, footnote 5, at p. 475.

3. *Ab Initio* Subordination and Subsequent Subordination

A further division focuses on the parties to the subordination agreement. The subordination provision may be contained in the contract between the debtor and the subordinating creditor (as in cases 3 and 4). The creditor who receives the benefit of the subordination is not a party to this agreement. In the other cases, the contract is between the subordinating creditor and the creditor who receives the benefit of the subordination. The former are said to involve an *ab initio* subordination because the obligation or security interest created by the debtor is, from its very inception, subordinated to the claim or security interest of the senior or benefiting creditor.[18] In the other cases, the debt or security interest is first created through an agreement between the creditor and the debtor and then later subordinated through an agreement entered into between the subordinating creditor and the other creditor.

Because an *ab initio* subordination involves a third-party beneficiary who is not a party to the agreement, the beneficiary may encounter difficulties when attempting to enforce the agreement, because the beneficiary is not privy to the contract.[19] Where the parties provide for the subordination of a security interest governed by a Personal Property Security Act[20] (PPSA), the subordination will be enforceable by the non-contracting creditor, despite the lack of privity. The PPSA contains an express provision that permits the third party to enforce a security interest subordination (Case 4), as long as the third party is within the class of persons for whose benefit it was intended.[21] This provision does not apply in respect of a debt subordination agreement (Case 3). It is likely that Canadian courts

18. R.M. Zinman, "Under the Spreading U.C.C. – Subordinations and Article 9" (1965), 7 B.C. Ind. & Com. Law Rev. 1 at pp. 6-7; MacDougall, *supra*, footnote 11, at p. 231. Case 3 is sometimes referred to as an institutional subordination (as opposed to a private subordination) because the subordination arises in connection with a public or private issuance of securities to institutional investors. See Lopes, *supra*, footnote 2, at p. 206; Kravitz, *supra*, footnote 2, at pp. 285-286.
19. See McDougall, *supra*, footnote 11, at pp. 250-251; E.M.A. Kwaw, *The Law of Corporate Finance in Canada* (Markham, Butterworths, 1997), pp. 289-294.
20. Personal Property Security Act, R.S.A. 2000, c. P-7 (APPSA), s. 35(1); Personal Property Security Act, R.S.O. 1990, c. P.10 (OPPSA), s. 30(1). The Alberta Act will be used as representative of the common law jurisdictions — other than Ontario — that use a substantially similar model.
21. OPPSA, s. 38; APPSA, s. 40. The OPPSA provision is not as explicit, but the courts have held that it permits the enforcement of the promise by a third-party beneficiary. See *Euroclean Canada Inc. v. Forest Glade Investments Ltd.* (1985), 16 D.L.R. (4th) 289, 49 O.R. (2d) 769 (C.A.), leave to appeal to S.C.C refused 16 D.L.R. (4th) 289*n*, [1985] 1 S.C.R. viii.

will be willing to find an exception[22] to the privity doctrine in respect of a contractual debt subordination created in the contract between the debtor and the junior creditor.

A privity of contract issue may also arise where a subordinating creditor and the debtor agree to de-subordinate a security interest. For example, a secured party and a debtor may agree to a new security agreement as part of a refinancing arrangement. This may involve the replacement of an old security agreement, which contains a subordination provision, with a new security agreement, which does not contain a subordination provision.[23]

IV. DEBT SUBORDINATION AGREEMENTS

1. Types of Debt Subordination Provisions

Many of the legal issues associated with debt subordination agreements will turn on whether the contract creates merely a personal obligation on the part of the junior creditor or transfers a property right from the junior creditor to the senior creditor.[24] This, in turn, will depend on the drafting of the subordination agreement and the interpretation given to it by the courts. There are several possibilities open to the parties. First, the parties may choose to create merely a personal obligation on the junior creditor to refrain from obtaining payment from the debtor or from enforcing its claim against the debtor until the claim of the senior creditor is satisfied. This does not involve a transfer of a property right by the junior creditor. The provision is really no different from any other negative covenant given by the debtor. The breach of the provision gives the senior creditor the right to sue the debtor and to recover damages for

22. Where a debt subordination agreement requires the junior creditor to hold any funds received in trust for the senior creditor, the traditional trust exception to the privity rule can be asserted. See *Stelco Inc. (Re)* (2007), 35 C.B.R. (5th) 174, 32 B.L.R. (4th) 77 (Ont. C.A.). In other cases, the court may need to invoke the newer principled exception to the privity doctrine that was confirmed by the Supreme Court of Canada in *Fraser River Pile & Dredge Ltd. v. Can-Dive Services Ltd.*, [1999] 3 S.C.R. 108, 176 D.L.R. (4th) 257. In order to fall within this exception, it must be shown that the parties to the contract intended to confer a benefit on the third party and that the actions in question came within the scope of agreement between the initial parties.

23. See Cuming, Walsh and Wood, *supra*, footnote 6, at p. 370. For the position in the United States, see J.A. Hauser, "Nonconsensual Repeal of Third-Party Beneficiary Contract Rights: Senior Creditors under Subordination Agreements" (1987), 8 Cardozo L.R. 1227.

24. See R.M. Goode, *Commercial Law*, 3rd ed. (London, LexisNexis Butterworths, 2004), pp. 614-616; Powell, *supra*, footnote 13, at p. 379.

breach of contract. This type of provision is, therefore, referred to as a contractual subordination.[25]

A debt subordination agreement may also provide for the event that the junior creditor receives payments in violation of the agreement. The contract may create merely a personal obligation to repay any amounts improperly received. The junior creditor is not required to hold these funds in trust, but is simply required to pay an equivalent amount to the senior creditor. This gives the senior creditor the right to bring a personal action against the junior creditor for this sum.[26] It does not give the senior creditor any proprietary right in the assets of the junior creditor.[27] Alternatively, the debt subordination agreement may give the senior creditor a property right in any funds that are improperly paid to the junior creditor. This is usually done through the creation on an obligation on the part of the junior creditor to hold the funds in trust for the senior creditor.[28] Under this arrangement, the senior creditor will obtain a proprietary right in the funds in the hands of the junior creditor. Of course, this will only be effective to the extent that the original funds can be identified or where their traceable proceeds remain in the hands of the debtor.[29]

Most debt subordination agreements will also specifically provide for the insolvency of the debtor. Again, there are different types of obligations that can be incurred by the junior creditor. The junior creditor might simply promise not to prove a claim in the insolvency proceedings until the claim of the senior creditor has been fully satisfied. This operates in the same way as the obligation not to receive payments from the debtor or enforce the debt. The junior creditor provides a negative covenant under which it promises to refrain from asserting a claim. The senior creditor has a personal action against the junior creditor if the junior creditor were to breach this promise.[30]

Alternatively, the debt subordination agreement may provide a turnover provision under which the junior creditor is required to prove its claim in the insolvency proceedings and pay any proceeds, dividend or other distribution to the senior creditor. This might

25. See *Maxwell Communications Corp. Plc (Re)*, [1993] 1 W.L.R. 1402 (Ch. D.) at p. 1405.
26. Goode, *supra*, footnote 24, at pp. 615-616.
27. *SSSL Realisations (2002) Ltd. (Re)*, [2004] EWHC 1760 (Ch. D.) at para. 55, aff'd [2006] EWCA Civ. 7 (C.A.).
28. P. Wood, *supra*, footnote 3, at p. 185.
29. See R. Wood, *supra*, footnote 2, at pp. 145-148.
30. Goode, *supra*, footnote 24, at p. 616.

involve a personal obligation on the part of the junior creditor to pay an equivalent amount to the senior creditor.[31] In this case, there is simply a contractual promise to pay the amount of the dividend or distribution to the senior creditor. The senior creditor does not thereby obtain a proprietary right to this fund.[32] The subordination agreement may, instead, impose an obligation on the junior creditor to hold any dividends or other distributions in trust for the senior creditor. This has been referred to as a turnover trust.[33] In this case, the senior creditor obtains a proprietary right in these funds.

There are two major differences between contractual subordination and turnover subordination. First, contractual subordination will often operate to the advantage of creditors who are not party to the debt subordination agreement. This is illustrated in the following example. Suppose that A, B, and C are unsecured creditors of a common debtor. A agrees not to assert a claim until B's claim is satisfied. The debtor subsequently goes bankrupt. A is thereby precluded from asserting its claim in the bankruptcy. As a result, B and C will prove their claims in bankruptcy and obtain a pro rata distribution. The benefit of the contractual subordination is therefore conferred on all of the creditors.[34]

Second, turnover subordination confers an additional benefit on the senior creditor in that it gives the senior creditor the ability to claim a double dividend in the bankruptcy.[35] Suppose that A, B, and C are each owed $100. A agrees to turnover amounts received to B. A, B, and C will each prove their claims in the bankruptcy. If a bankruptcy dividend of 30 cents on the dollar were declared, then each creditor would receive $30. A must then pay this dividend to B. The end result is that A would recover nothing, B would recover $60, and C would recover $30.[36]

This does not exhaust all possibilities. Less common devices are also possible. The obligation owed to the junior creditor may be structured as a contingent debt in which, either from its inception or

31. Powell, *supra*, footnote 13, at p. 372.
32. Goode, *supra*, footnote 24, at p. 615; P. Wood, *supra*, footnote 3, at p. 186; Kwaw, *supra*, footnote 19, at p. 299.
33. P. Wood, *supra*, footnote 3, at p. 185; Powell, *supra*, footnote 13, at pp. 371-372.
34. MacDougall, *supra*, footnote 11, at p. 266; Carlson, *supra*, footnote 7, at p. 984.
35. P. Wood, *supra*, footnote 3, at p. 188.
36. The double-dividend effect arises from the turnover obligation. If the turnover obligation is merely a personal obligation on the part of the junior creditor to pay an equivalent amount to the senior creditor, the senior creditor has merely a personal claim against the junior creditor for $30 and takes the risk of the junior creditor's insolvency. If a turnover trust is involved, then the senior creditor would have a proprietary claim to the junior creditor's dividend.

on a specified event — such as the insolvency of the debtor — the obligation to pay is conditioned on full repayment of the senior creditor's debt.[37] Alternatively, the transaction may involve an outright assignment of the junior creditor's claim to the senior creditor.[38]

2. Legal Issues

Debt subordination agreements give rise to the following legal issues:

- Do debt subordination agreements violate the pro rata sharing principle on a bankruptcy of the debtor?
- Assuming that debt subordination agreements are effective in bankruptcy, does a trustee in bankruptcy have the power to enforce a debt subordination agreement when making a distribution to creditors?
- In the event of a dual bankruptcy of both the debtor and the junior creditor, what is the status of the senior creditor's claim under a debt subordination agreement in the bankruptcy of the junior creditor?
- What is the status of the senior creditor's claim under a debt subordination agreement if the junior creditor were to subsequently assign its debt to a third party?
- What is the status of the senior creditor's claim under a debt subordination agreement if the junior creditor were to subsequently subordinate its debt to another creditor?

3. The Pro Rata Sharing Principle of Bankruptcy Law

The Bankruptcy and Insolvency Act[39] provides for a rule of pro rata sharing amongst ordinary unsecured creditors after the claims of the preferred creditors have been paid.[40] The pro rata (or *pari passu*) sharing principle is viewed as one of the foundational principles of bankruptcy law[41] and courts in the United Kingdom and

37. B. Johnston, "Contractual Debt Subordination and Legislative Reform", [1991] J.B.L. 225 at p. 226; Powell, *supra*, footnote 13, at pp. 370-371.
38. Weil, *supra*, footnote 5, at pp. 478-480; Kwaw, *supra*, footnote 19, at p. 300; Manzer and Ruda, *supra*, footnote 5, at pp. 321-322.
39. R.S.C. 1985, c. B-3 (BIA).
40. BIA, s. 141. See also *Orzy (Re)*, [1924] 1 D.L.R. 250, 3 C.B.R. 737 (Ont. C.A.).
41. See R.M. Goode, *Principles of Corporate Insolvency Law*, 3rd ed. (London, Sweet & Maxwell, 2005), pp. 175-176. Other commentators have questioned whether or not the *pari passu* sharing principle should be seen as a fundamental principle, given that the bulk of the assets are often distributed to preferred creditors whose

commonwealth countries have held that it is not open for the debtor to stipulate with a creditor so as to provide for a different distribution than that provided under the insolvency regime.[42] There was considerable uncertainty initially on whether or not the pro rata sharing principle invalidated the use of subordination agreements on bankruptcy. Legal opinions were qualified in order to reflect this uncertainty[43] and alternative financing techniques were sometimes employed in an attempt to circumvent the principle. Because it was thought that contractual subordinations were particularly vulnerable, parties would rely instead upon turnover subordination provisions or create contingent debt subordinations under which the debt did not come into existence until the claims of the senior creditors were satisfied.[44]

Subsequent cases have largely dispelled this concern. Cases from Australia,[45] the United Kingdom[46] and the United States[47] have held that subordination agreements do not offend the pro rata sharing policy of bankruptcy law, since they involve a consensual variation of the junior creditor's rights and do not prejudice the ranking of other non-consenting creditors. Although there are no authoritative Canadian cases that uphold debt subordination agreements in bankruptcy,[48] commentators have become strongly inclined to the view that they should not be found to contravene the pro rata sharing principle of bankruptcy law.[49] There is much to be said in support of this view. Courts have long protected the scheme of distribution in bankruptcy against devices that attempt to deprive creditors of their

claims must be satisfied before those of the ordinary creditors. See R.J. Mokal, "Priority as Pathology: The *pari passu* Myth" (2001), 60 Camb. L.J. 581.

42. *MacKay (Ex p.)* (1873), 8 Ch. App. 643; *British Eagle International Airlines Ltd. v. Compagnie Nationale Air France*, [1975] 1 W.L.R. 758; *New Zealand Attorney-General v. McMillan & Lockwood Ltd.*, [1991] 1 N.Z.L.R. 53 (C.A.).

43. L.C. Ho, "A Matter of Contractual and Trust Subordination" [2004] J.I.B.L.R. 494 at p. 494.

44. See Johnston, *supra*, footnote 37, at pp. 22-27; Powell, *supra*, footnote 13, at pp. 370-372.

45. *Horne v. Chester & Fein Property Developments Pty. Ltd.* (1987), 5 A.C.L.C. 245 (Vict. S.C.) (Aus.).

46. See *Maxwell Communications Corp. Plc (Re)*, *supra*, footnote 25; *SSSL Realisations (2002) Ltd. (Re)*, *supra*, footnote 27.

47. *Aktiebolaget Kreuger & Toll*, 96 F.2d 768 (2d Cir. 1938).

48. See MacDougall, *supra*, footnote 11, at pp. 264-265; Kwaw, *supra*, footnote 19, at pp. 287-298. See also *Air Canada (Re)* (2004), 2 C.B.R. (5th) 4, 130 A.C.W.S. (3d) 899 (Ont. S.C.J. (Comm. List)), which reviews the Canadian authorities, but which was itself dealing with a restructuring rather than a bankruptcy.

49. MacDougall, *ibid.* at pp. 264-266; Kwaw, *ibid.* at pp. 298-298; Kent, supra, footnote 3.

just share without their consent,[50] but this should not prevent a creditor from voluntarily waiving or subordinating its claim to other creditors. Courts have taken the view that, as it is open to a creditor to waive its claim completely or decline to submit a proof, there is no reason why the a creditor should not also be able to waive it until the other unsecured creditors are paid in full.[51]

4. Enforcement of Subordination Agreements in Bankruptcy

On the assumption that Canadian courts will uphold the validity of a debt subordination agreement in bankruptcy, a procedural issue then arises. Does the trustee in bankruptcy have the power to give effect to the subordination agreement when making a distribution to the creditors? If the subordination agreement were viewed merely as a private arrangement between the creditors, then the distribution would be properly made to the junior creditor and it would be up to the parties to enforce the terms of the subordination agreement outside of the bankruptcy forum. In a contractual subordination, the remedy available to the senior creditor is a personal action against the junior creditor for breach of contract for submitting a proof of claim in violation of the agreement. In a turnover trust subordination, the senior creditor has both personal remedies against the junior creditor for breach of trust as well as proprietary remedies in respect of the trust property or its traceable proceeds.[52]

But if the trustee in bankruptcy were empowered to give effect to a debt subordination agreement, it could be directly enforced through the adjustment of distributions to the respective creditors. The trustee in bankruptcy would be responsible for ensuring that junior creditor's dividend was paid to the senior creditor in a turnover subordination and that no dividend was paid to the junior creditor until the claim of the senior creditor was satisfied in a contractual subordination.

Courts in the United States have permitted the enforcement of subordination agreements in bankruptcy[53] and the current United States' Bankruptcy Code specifically provides that a subordination agreement is enforceable to the same extent as under applicable

50. *Husky Oil Operations Ltd. v. M.N.R.*, [1995] 3 S.C.R. 453, 128 D.L.R. (4th) 1.
51. *Maxwell Communications Corp. Plc (Re)*, *supra*, footnote 25, at pp. 1411-1412.
52. See J.E. Penner, *The Law of Trusts*, 5th ed. (Oxford, Oxford University Press, 2006), at pp. 296-300 and pp. 332-334.
53. See E. Everett, "Subordinated Debt — Nature, Objectives and Enforcement" (1964), Boston U. Law Rev. 487 at pp. 506-518.

non-bankruptcy law.[54] Clearly, the view in the United States is that a trustee in bankruptcy should be able to give effect to the subordination agreement, so as to prevent the junior creditor from reneging on its obligation and to circumvent any need for further litigation.

In Canada, the powers of the bankruptcy court are more circumscribed. Canadian bankruptcy courts have been reluctant to exercise jurisdiction to determine contractual disputes between creditors. In *Re Orzy*, the court stated that "the practice in bankruptcy does not permit of the adjustment of the rights and privileges of creditors *inter se*."[55] Although it appears that contractual adjustments between the creditors can be taken into account with the consent of the parties, the proper course of action is to require the parties to resolve it in the ordinary courts when matters are disputed.[56]

Where the debt subordination agreement provides for the transfer of the junior creditor's claim to the senior creditor, a different process can be invoked. The senior creditor stands in the position of an assignee and may prove the claim in the bankruptcy and have it substituted for any proof of claim made by the assignor.[57]

5. The Senior Creditor's Claim on a Bankruptcy of the Junior Creditor

The foregoing has demonstrated that a debt subordination agreement is almost certainly effective in a bankruptcy of the debtor, although, in Canada, it may be necessary to enforce its terms in the ordinary courts where the junior creditor fails to perform the terms of a contractual subordination. There is no need for registration of a debt subordination agreement under personal property security legislation in order to make it effective against the trustee in bankruptcy of the debtor. A perfection requirement only comes into play in respect of a security interest given by the debtor. The debtor does not a transfer any proprietary right to the senior creditor under a debt subordination.[58]

54. 11 U.S.C. § 510.
55. *Supra*, footnote 40, at p. 260 D.L.R.
56. *Rico Enterprises Ltd. (Re)* (1994), 24 C.B.R. (3d) 309, 92 B.C.L.R. (2d) 67 (S.C.).
57. *Frost (In re)*, [1899] 2 Q.B. 50 (Div. Ct.); *Maple Leaf Fruit Co. (Re)* (1949), 30 C.B.R. 23, [1949] 3 D.L.R. 426 (N.S.S.C.).
58. See Cuming, Walsh and Wood, *supra*, footnote 6, at pp. 87-89. To the extent that there is a transfer of a proprietary right under a subordination agreement, it is given by the junior creditor to the senior creditor.

Problems arise when both the debtor and the junior creditor are bankrupt. This is more likely to occur when an insider of the debtor gave the subordination agreement, as their financial situations are often linked.[59] The question concerns the status of the senior creditor's claim under the subordination agreement in the bankruptcy of the junior creditor. This is one of the most hotly debated issues in the secondary literature on subordination agreements.[60]

The starting point is to recognize that, in bankruptcy, a sharp distinction is drawn between personal claims against the debtor and proprietary claims to the debtor's assets. Proprietary claims can be asserted against the trustee with the result that the asset is withdrawn from the bankrupt estate. Personal claims are converted into a right to prove for a dividend.

(a) The Effect of Bankruptcy on Personal Obligations

In a contractual subordination, there is a merely personal obligation on the part of the junior creditor to refrain from enforcing its claim until the claim of the senior creditor is satisfied. On a bankruptcy of the junior creditor, the assets of the junior creditor — including the debt owed to it by the debtor — vest in the junior creditor's trustee in bankruptcy and are used to generate funds that are used to pay a dividend to claimants who hold personal claims against the debtor. Where the senior creditor has a merely personal right against the debtor, the only recourse is to prove a claim for contractual damages in respect of the subordination agreement. The same holds true in respect of contractual provisions that require a junior creditor to pay an amount equivalent to any payments improperly received from the debtor and to turnover provisions that

59. See P. Coogan, H. Kripke and F. Weiss, "The Outer Fringes of Article 9: Subordination Agreements, Security Interests in Money and Deposits, Negative Pledge Clauses, and Participation Agreements" (1965), 79 Harv. L.R. 229 at p. 235.

60. Coogan, Kripke and Weiss, *ibid.*, at pp. 235-259; Gilmore, *supra*, footnote 1, at pp. 988-998; G. Gilmore, "Article 9: What it Does Not Do For the Future" (1966), 26 La. L.R. 300 at pp. 303-304; Zinman, *supra*, footnote 18, at pp. 28-31; R.M. Zinman, "Under the Spreading Bankruptcy – Subordinations and the Codes" (1994), 2 Amer. Bank. Inst. L.R. 293; J.R. Hudson, P.E. Mears and J.A. Goatley Moreno, "Revisiting the Outer Fringes: Contractual Subordination in Dual Bankruptcy Cases" (1993), 98 Com. L.J. 417; M.D. Heileson and M.W. Hirsh, "Private Subordination Agreements and the U.C.C.: Is Section 1-209 an Un-*Wyse* Solution?" (1983), 38 Bus. Law. 555; MacDougall, *supra*, footnote 11, at pp. 267-268; Powell, *supra*, footnote 13, at pp. 379-381; Johnston, *supra*, footnote 37, at pp. 239-243; P. Wood, *supra*, footnote 3, at pp. 199-202.

merely require the junior creditor to pay the senior creditor an amount equal to the dividend that the junior creditor obtains on a bankruptcy of the debtor.[61] In none of these cases does the senior creditor have a proprietary right in the assets of the junior creditor.

This means that a senior creditor is exposed to the risk of the junior creditor's insolvency, since the senior creditor has merely a right to prove a claim for damages in the bankruptcy of the junior creditor. The senior creditor — like any other contracting party who does not obtain a proprietary right in the assets of the insolvent person — would therefore share pro rata with other unsecured creditors who prove their claims in bankruptcy. Yet in England and in the United States, it appears that a contractual subordination may nevertheless be effective in the bankruptcy of the junior creditor. When one examines the insolvency legislation in those jurisdictions, however, it becomes clear that these outcomes are the product of statutory provisions that have no counterpart in Canada.

The position in the United States is the subject of some controversy. The Bankruptcy Code of the United States expressly provides that "[a] subordination agreement is enforceable . . . to the same extent that such agreement is enforceable under non-bankruptcy law."[62] Some have argued that this is simply declarative of pre-existing case law and means only that the subordination agreement is enforceable in the bankruptcy of the debtor.[63] On this view, the provision has no application in the bankruptcy of the junior creditor. Where the subordination agreement creates only contractual rights in favour of the senior creditor, the senior creditor obtains only a right to prove a claim for breach of contract in the bankruptcy of the junior creditor.[64] Others have argued that the provision covers dual bankruptcies of the debtor and junior creditor.[65] This would mean that a contractual subordination would be fully enforceable, despite the insolvency of the junior creditor.

The leading decision in England and Wales dealing with the effectiveness of a contractual subordination on the insolvency of a junior creditor is the decision of the Court of Appeal in

61. Powell, *supra*, footnote 13, at p. 372; Goode, *supra*, footnote 24, at pp. 614-616; P. Wood, *supra*, footnote 3, at p. 186.
62. 11 U.S.C. § 510(c).
63. Heileson and Hirsh, *supra*, footnote 60, at p. 557.
64. *Ibid.*, at pp. 562-563.
65. Zinman, "Under the Spreading Bankruptcy – Subordinations and the Codes", *supra*, footnote 60, at pp. 328-329.

Re SSSL *Realisations (2002) Ltd.*[66] Despite the fact that one of the subordination provisions was found to create only a contractual subordination in favour of the senior creditor,[67] the senior creditor was not limited to proving a claim in the junior creditor's liquidation, but was able to insist on enforcement of the contract.[68] It was able to do so through the application of the statutory provisions governing the disclaimer of contracts under the Insolvency Act, 1986.[69] Under English insolvency law, the obligations under existing contracts are not brought to an end by the commencement of liquidation proceedings; however, the liquidator is given the right to disclaim unprofitable contracts. The Court of Appeal held that the contract did not qualify as an unprofitable contract and, therefore, could not be disclaimed. Although it was detrimental to the creditors of the junior creditor, it did not create prospective liabilities or delay the liquidators from discharging their functions.[70]

Canadian bankruptcy legislation has no counterpart to these legislative provisions.[71] There is nothing similar to the United States provision that renders a subordination agreement enforceable to the same extent as under non-bankruptcy law. Furthermore, the Canadian treatment of executory contracts is fundamentally different from that in England. The principles governing the treatment of executory contracts in bankruptcy arise only where there are unperformed contractual obligations that are owed by both the bankrupt and the counterparty.[72] This will not generally be the case in respect of a subordination agreement, since the unperformed obligation will typically be that owed by the junior creditor to the senior creditor; and even if the contract were regarded as an executory contract, the trustee's ability to disclaim it would not be limited to cases where the contract was unprofitable.

As there are no legislative provisions that provide a contrary rule, the effectiveness of a subordination agreement in the bankruptcy of a junior creditor will fall to be determined by ordinary bankruptcy law

66. SSSL *Realisations (2002) Ltd. (Re)*, *supra*, footnote 27 (Ch. D.).
67. SSSL *Realisations (2002) Ltd. (Re)*, *supra*, footnote 27 (C.A.), at para. 55.
68. SSSL *Realisations (2002) Ltd. (Re)*, *supra*, footnote 27 (Ch. D), at para. 52.
69. 1986 (U.K.), c. 45, s. 178.
70. SSSL *Realisations (2002) Ltd. (Re)*, *supra*, footnote 27 (C.A.), at para. 52.
71. See *New Skeena Forest Products Inc. v. Don Hull & Sons Contracting Ltd.* (2005), 9 C.B.R. (5th) 267, 251 D.L.R. (4th) 328 (B.C.C.A.), at paras. 24-29. This means that the common law rules concerning disclaimer of contracts in bankruptcy will apply.
72. A. Duggan, "Partly Performed Contracts" in *Canadian Bankruptcy and Insolvency Law: Bill C-55, Statute c. 47 and Beyond*, S. Ben-Ishai and A. Duggan, eds. (Markham, Lexis Nexis Canada, 2007), at pp. 25-26.

principles. The senior creditor who has a merely personal right of action against the junior creditor will have only the right to prove a claim in the bankruptcy of the junior creditor.

(b) The Effect of Bankruptcy on Proprietary Rights

The analysis is different where the subordination agreement gives the senior creditor a proprietary right in the assets of the junior creditor. The subordination agreement may provide that the junior creditor agrees to hold payments and dividends in trust for the senior creditor. This clearly gives the senior creditor a proprietary right to these funds; however, this raises the further issue as to whether the provision creates a security interest such that it must be registered under the PPSA in order to assert priority over the junior creditor's trustee in bankruptcy. A failure to perfect a security interest results in its being rendered ineffective against the bankrupt's trustee in bankruptcy.[73] Where a turnover trust in substance creates a security interest, it would be necessary for the senior creditor to perfect it in order to prevail against the junior creditor's trustee in bankruptcy. The senior creditor could do so by registering a financing statement against the name of the junior creditor. A failure to do so would relegate the senior creditor to the status of an unsecured creditor who could prove its claim in the bankruptcy.[74]

There are three arguments that might be made in support of the view that a turnover trust provision does not fall within the scope of the PPSA. The first argument is that the transaction does not secure payment or performance of an obligation. The second argument is that at least some debt subordinations do not involve a transfer by the junior creditor to the senior creditor. The third argument is that the legislation in some provinces excludes the operation of the PPSA.

The first argument relies on English authority. In *Re SSSL Realisations (2002) Ltd.*,[75] the Court of Appeal held that, although a turnover trust created a proprietary right in the junior creditor's assets, it was not a registerable charge on book debt. The court concluded that the trust was limited to payments received by the junior creditor up to the amount of the senior creditor's claim and, therefore, concluded that it created an absolute assignment of part of the debt, rather than a charge on the entire debt.[76] This argument will

73. OPPSA, s. 20(1)(b); APPSA, s. 20(a).
74. See Cuming, Walsh and Wood, *supra*, footnote 6, at pp. 87-89.
75. *Supra*, footnote 27 (C.A.).
76. This aspect of the decision has been criticized. Although it is possible, in theory, to create a trust in respect of money received from a debtor up to the limit of the

not succeed in Canada. The PPSA has a greater reach than does the English legislation. A registration requirement is not limited to a charge on book debts,[77] but extends to both an absolute as well as a security transfer of an account.[78] The interest created pursuant to the trust provision falls within the definition of a security interest. It creates a proprietary right to the account (*i.e.*, the monetary obligation) owed by the common debtor to the junior creditor.

The second argument has a more limited application. It is restricted to *ab initio* debt subordinations in which the subordination of the junior creditor is contained in the contract between the debtor and the junior creditor that creates the junior debt. The argument here is the transaction does not fall within the definition of a security interest because there is no transfer of a proprietary right by the junior creditor to the senior creditor. The obligation that is owed to the junior creditor from its inception has a subordinate ranking to the claim held by the senior creditor. The subordination does not arise because of a transfer by the junior creditor to the senior creditor, but results because the junior creditor has acquired lesser rights from its contract with the debtor.[79] Since the junior creditor never had any rights that it could transfer, the transaction cannot qualify as a security interest.

The difficulty with this theory is that it does not adequately explain how the senior creditor acquires the right to the junior creditor's

junior creditor's claim, it seems unlikely that this was what the parties intended in this particular case. If the senior creditor's debt were subsequently reduced or repaid in full, the senior creditor would nevertheless be entitled to the money held in trust. It is more likely that the parties would have intended that the senior creditor could resort to the funds only to point that its claim is satisfied. If so, that would demonstrate that the senior creditor had only a right to look to the funds as security for repayment of its debt and was not entitled to claim beneficial owner of the fund if there was surplus. See Ho, *supra*, footnote 43, at pp. 497-498.

77. In addition, the English registration requirement was only engaged in respect of an assignment of a debt. The right to receive a bankruptcy dividend is not considered to be a debt, since it is not recoverable by an action in debt against the trustee, but through a court application seeking an order requiring the trustee to fulfill his or her duty. See BIA, s. 148(3). See also *Moir v. Franciotta* (1931), 13 C.B.R. 27, 40 O.W.N. 485 (Ont. Co. Ct.); *Monarch Lumber Co. v. Klotz* (1947), 28 C.B.R. 85, [1947] 1 W.W.R. 543 (Sask. Dist. Ct.). This does not, however, prevent the right to the dividend from being assigned. See *Hattle's Feed Mill Ltd. (Re)* (1975), 20 C.B.R. (N.S.) 229, 59 D.L.R. (3d) 488 (Ont. S.C.). The PPSA is broader than the English legislation, as it is not limited to assignments of debts, but covers any transfer of a monetary obligation. This is clearly wide enough to cover the right to a bankruptcy dividend.

78. OPPSA, s. 2(b); APPSA, s. 3(2).

79. Coogan, Kripke and Weiss, *supra*, footnote 59, at pp. 238-242; Zinman, "Under the Spreading Bankruptcy – Subordinations and the Codes", *supra*, footnote 60, at pp. 302-306.

dividend (the double dividend effect). If an *ab initio* subordination operates by giving the junior creditor lesser rights, this should be taken into account by the trustee in bankruptcy when valuing the claim — the junior creditor should receive a smaller bankruptcy dividend or none at all. But this is not what happens. Under a turnover trust subordination, the junior creditor proves a claim for the full amount and holds the bankruptcy dividend in trust for the benefit of the senior creditor. The senior creditor thereby acquires the junior creditor's claim, and this must result by virtue of a transfer of it.

The third argument is limited to British Columbia, Saskatchewan, the Northwest Territories and Nunavut. In these jurisdictions, an additional provision has been added to the PPSA. It provides that an agreement to subordinate or postpone a debt or a security interest "does not, by virtue of the subordination or postponement alone, create a security interest."[80] It might be argued that this provision applies to all subordination provisions, whether contractual or in the form of a turnover trust and, therefore, brings the latter outside of the scope of the PPSA. In the absence of any legislative provision that renders ineffective the proprietary interest held by the senior creditor, the senior creditor would be entitled to assert its proprietary right as against the trustee in bankruptcy of the junior creditor.[81]

This argument does not adequately take into account the language used in the provision. The provision draws a distinction between a subordination provision *simpliciter* and one that contains an additional element in the form of a transfer of the junior creditor's claim to the senior creditor. This corresponds to the division between a contractual subordination provision that imposes only a personal obligation on the part of the junior creditor and other types of provisions that give the senior creditor a proprietary right in the property of the junior creditor.[82] On this view, a subordination agreement that contains a turnover trust provision or one that involves an assignment of the junior creditor's claim possesses an additional element that brings the PPSA into play; however, a promise not to assert a claim until the senior creditor is paid would not create a security interest. An advantage of this interpretation is that it produces uniformity across Canada. If the contrary position were accepted, this would mean that unperfected turnover trust

80. Personal Property Security Act, R.S.B.C. 1996, c. 359, s. 40(2); Personal Property Security Act, 1993, S.S. 1993, c. P-6.2, s. 40(2); Personal Property Security Act, S.N.W.T. 1994, c. 8, s. 40(2).

81. See R. Wood, *supra*, footnote 2, at pp. 123-125.

82. See the discussion under heading IV(1), "Types of Debt Subordination Provisions".

subordinations would be effective against the junior creditor's trustee in bankruptcy in the four jurisdictions that added the special provision and would be ineffective in all the other jurisdictions.

6. Assignment of the Debt by the Junior Creditor

Disputes over the operation of debt subordination agreements can also arise when a junior creditor enters into a debt subordination agreement with a senior creditor, following which the junior creditor transfers the debt to a transferee. The issue is whether or not the transferee acquires the debt free from the operation of the subordination agreement. Where the subordination provision creates only a personal obligation on the part of the junior creditor, the transferee of the debt will not be affected by the subordination.[83] Since the senior creditor has no proprietary right in respect of the asset, the junior creditor has the power to sell it to a transferee free of the senior creditor's claim.[84]

The senior creditor may attempt to protect itself by including a negative covenant in the subordination agreement whereby the junior creditor promises not to assign the debt. Although it may give the senior creditor additional remedies against the junior creditor for breach of contract, it does not alter the fact that the senior creditor has only a contractual right against the junior creditor that cannot be asserted against a third party who acquires the junior creditor's claim. Where the third-party transferee knows of the negative covenant, but nevertheless enters into a contract for the assignment of the debt, the senior creditor may be able to bring a personal action against the transferee for the economic tort of inducing breach of contract if there were an intentional and knowing procurement of the breach.[85]

Where the subordination agreement creates a proprietary interest in the debt, the priorities will be governed by the PPSA and priority will be given to the first to register.[86] In principle, it should not make any difference if the transferee knew of the subordination agreement

83. See Kent, *supra*, footnote 3, at p. 39.

84. See *Royal Bank of Canada v. Body Blue Inc.* (2008), 42 C.B.R. (5th) 125, 13 P.P.S.A.C. (3d) 176 (Ont. S.C.J. (Comm. List)), in which a technology licence that gave the licensee a contractual right to use the technology did not prevent a conveyance of the technology to a third-party transferee.

85. See *Fabbi v. Jones*, [1973] S.C.R. 42, 28 D.L.R. (3d) 224. The action, however, will not lie in respect of a priority competition between competing assignees of the debt, since the matter is properly resolved through the application of the PPSA priority rules. See *Bank of Nova Scotia v. Gaudreau* (1984), 48 O.R. (2d) 478, 27 B.L.R. 101 (H.C.J.).

86. OPPSA, s. 30(1); APPSA, s. 35(1).

between the junior creditor and the senior creditor, since knowledge of an unperfected security interest would not prevent a secured party from relying on the priority rules of the PPSA. The transferee would be precluded from doing so only if its conduct were to amount to bad faith.[87]

7. Successive Subordinations

Further complications arise where a junior creditor subordinates its claim to A and then later, subordinates the same claim to B. One commentator has suggested that the matter should be resolved using the same common law principles that are used to resolve priority competitions between successive assignments.[88] There is little to commend this view, since it ignores the different types of legal rights created by the various types of subordination agreements. It is not appropriate to use property law concepts to resolve such competitions, unless both of the subordination agreements create a transfer of the junior creditor's claim;[89] and even if property law principles were to be applied, it would be the PPSA and not prior common law concepts that provide the applicable priority rules in respect of competing security interests.

Successive subordination agreements do not create any problems where both agreements involve a contractual subordination, since there is no transfer of the junior creditor's claim. Both A and B will be entitled to have their claims paid before the junior creditor is paid.[90] A dispute will arise if the junior creditor: (1) were to enter into a contractual subordination with A and then agree to a turnover trust subordination to B; or (2) were to enter into a turnover trust subordination with A and then agree to a second turnover trust subordination to B. In the first case, priority should be given to B. B acquires the debt free of any claim held by A.[91] A is limited to a claim for damages for breach of contract against the junior creditor. In the

87. APPSA, s. 66(2) and (3). See also Cuming, Walsh and Wood, *supra*, footnote 6, at pp. 374-377.
88. See Calligar, *supra*, footnote 12, at p. 400.
89. See R. Golin, "Debt Subordination as a Working Tool" (1961), 7 N.Y. Law For. 370 at p. 371; Lopes, *supra*, footnote 2, at p. 221.
90. Indeed, it is generally thought that B can take advantage of the first subordination and does not have to rely on the second subordination. The junior creditor agrees not to assert its claim until A is fully paid and this will not occur until the claims of all ordinary creditors are satisfied in an insolvency of the debtor. The second subordination agreement may, however, be useful if there is a possibility of a waiver or contractual variation of the first subordination agreement.
91. See the discussion here under heading IV(6), "Assignment of the Debt by the Junior Creditor."

second case, both transfers are within the scope of the PPSA and priority should be based on the order of registration.

V. SECURITY INTEREST SUBORDINATION AGREEMENTS

1. Types of Security Interest Subordination Provisions

A subordination provision may be included in a security agreement between the secured party and the debtor.[92] Alternatively, it may be directly negotiated between a secured party and another creditor in an intercreditor agreement. Most of the recent Canadian cases on subordination agreements have involved clauses of the former pattern and are concerned with the issue whether the language contained in the security agreement amounts to an express or implied subordination of the security interest. There are fewer decisions concerning the interpretation of security interest subordinations in intercreditor agreements.

(a) Subordination Provisions in Security Agreements

Security agreements that cover circulating assets such as inventory or accounts will often give the debtor the right to deal with the asset in the ordinary course of its business. There was an early line of cases that held that this provision involved an implied subordination to any liens or other interests that arose as a result of an ordinary course dealing with the asset.[93] This implied license theory was ultimately rejected by the Supreme Court of Canada in *Royal Bank of Canada v. Sparrow Electric Corp.*[94] As a result, courts are unwilling to imply a subordination from a clause that gives the debtor the power to deal with the assets in the ordinary course of business.

Another line of cases has examined the use of covenants not to encumber the collateral (sometimes referred to as "negative pledge agreements"). The security agreement will typically contain a covenant under which the debtor agrees to keep the collateral free from all liens, encumbrances or security interests other than permitted encumbrances. The definition of permitted encumbrances will then specify the kinds of security interests that

92. See the discussion here under heading III(3), "*Ab Initio* Subordination and Subsequent Subordination."
93. See R.J. Wood, "Revenue Canada's Deemed Trust Extends its Tentacles: *Royal Bank of Canada v. Sparrow Electric Corp.*" (1995), 10 B.F.L.R. 429, for the history of the implied licence theory.
94. [1997] 1 S.C.R. 411, 143 D.L.R. (4th) 385.

can be incurred by the debtor without violating the covenant to keep the collateral free from encumbrances.[95] This definition is often structured so as to designate purchase-money security interests as permitted encumbrances.

Purchase-money security interests are afforded a special priority over ordinary security interests, as long as certain procedural steps are satisfied.[96] The controversy arises when a holder of a purchase-money security interest fails to comply with these requirements or fails to properly perfect its security interest. The purchase-money security interest holder would nevertheless prevail if it could prove that the competing secured party agreed to subordinate its security interest. The issue is whether or not the permissive provision amounts to an implied subordination of the security interest. Courts have held that a permissive provision alone does not constitute an implied subordination of the security interest,[97] but that it will amount to an implied subordination where combined with a prohibition against granting security interests that rank in priority to the security interest.[98] This means that a fundamental distinction is drawn between the two formulations reproduced below:

(1) The debtor shall keep the collateral free from all liens, security interests and encumbrances other than permitted encumbrances.

(2) The debtor shall keep the collateral free from all liens, security interests and encumbrances *ranking in priority or pari passu with the security interest* other than permitted encumbrances.

The provisions are identical except for the addition of the italicized language in the second clause. The first clause does not produce a subordination of the security interest to permitted encumbrances, whereas the second clause does so.[99]

95. See K.C. Morlock, "Floating Charges, Negative Pledges, the PPSA and Subordination: *Chiips Inc.* v. *Skyview Hotels Limited*" (1995), 10 B.F.L.R. 405.

96. OPPSA, s. 30(1) and (2); APPSA, s. 34(2) and (3).

97. *DCD Industries (1995) Ltd. (Re)* (2005), 11 C.B.R. (4th) 246, 253 D.L.R. (4th) 171 (Alta. C.A.); *Sperry Inc. v. Canadian Imperial Bank of Commerce* (1985), 17 D.L.R. (4th) 236, 50 O.R. (2d) 267 (C.A.); *Asklepeion Restaurants Ltd. v. 791259 Ontario Ltd.* (1996), 11 P.P.S.A.C. (2d) 320, 62 A.C.W.S. (3d) 1015 (Ont. Ct. (Gen. Div.)), affd 13 P.P.S.A.C. (2d) 295, 80 A.C.W.S. (3d) 435 (C.A.).

98. *Chiips Inc. v. Skyview Hotels Ltd.* (1994), 116 D.L.R. (4th) 385, 27 C.B.R. (3d) 161 (Alta. C.A.), leave to appeal to S.C.C. refused 116 D.L.R. (4th) vi, 30 C.B.R. (3d) 214*n*; *Hickman Equipment (1985) Ltd. (Re)* (2004), 2 C.B.R. (5th) 245, 7 P.P.S.A.C. (3d) 37 (Nfld. & Lab. C.A.). But see *Engel Canada Inc. v. TCE Capital Corp.* (2002), 34 C.B.R. (4th) 169, 4 P.P.S.A.C. (3d) 124 (Ont. S.C.J. (Comm. List)), which appeared to extend this principle to cases in which the permitted encumbrances provision was silent as to priorities.

Many of the earlier pre-PPSA security agreements, such as floating charge debentures, used the second formulation and, therefore, were at risk of subordination, despite a failure by the holder of a purchase-money security interest to take the steps needed to acquire priority under PPSA priority rules.[100] Modernized forms of security agreements, such as general security agreements, now generally adhere to the first pattern.[101] As a result, one can anticipate that it will become increasingly rare that a security interest will be subordinated on account of a subordination provision included in the security agreement.

(b) The Legal Nature of a Security Interest Subordination

The standard security interest subordination provision simply provides that the security interest of the subordinating creditor is subordinated or postponed or ranks below that of the benefiting creditor.[102] The difficulty with this formulation is that it does not precisely identify the nature of the obligation owed by the subordinating creditor or the nature of the interest, if any, obtained by the benefiting creditor pursuant to the agreement.

There are three possibilities. The first possibility is that the agreement may create merely a personal obligation on the part of the subordinating creditor not to enforce until the benefiting creditor has enforced its security interest against the collateral. This is, essentially, a promise to step aside and not to enforce or otherwise compete until the claim of the other party is satisfied.

The second possibility is that the subordination amounts to a partial waiver. When no other parties are involved, the subordinating creditor will refrain from enforcement. But, where any other third party makes a claim to the collateral, the subordinating creditor is permitted to enforce its security interest, although is subject to a personal obligation to account to the benefiting creditor for the proceeds of enforcement up to the value of the benefiting creditor's claim. The benefiting creditor does not thereby obtain an interest in the secured debt held by the subordinating creditor. A failure by the

99. See also A.B. Laidlaw, "PPSA Subordination: Has the Continuum Been Broken?" (2005), 21 B.F.L.R. 529.

100. See, *e.g.*, *Chiips v. Skyview Hotels Ltd.*, *supra*, footnote 98; *Euroclean Canada Inc. v. Forest Glade Investments Ltd.*, *supra*, footnote 21.

101. See, *e.g.*, the provisions of the general security agreements described in *Hickman Equipment (1985) Ltd. (Re)*, *supra*, footnote 98, and *Engel Canada Inc. v. TCE Capital Corp.*, *supra*, footnote 98.

102. See K.F. Leppman, *Security Documents: An Annotated Guide* (Aurora, Canada Law Book, 1999) at p. 176; Weil, *supra*, footnote 5, at p. 537.

subordinating creditor to fulfill this obligation gives the benefiting creditor an action for breach of contract.

The third possibility is that the agreement gives the benefiting creditor a proprietary right in the assets of the subordinating creditor in the form of an assignment of the secured debt. In theory, the assignment could be absolute or by way of security. It is unlikely that the parties would agree to an absolute assignment of the secured claim, as this would give the benefiting creditor the right to the entire amount of the debt, even if its claim against the debtor were fully satisfied from the proceeds.[103] It seems more likely that the parties will have intended to create a security assignment that gives the benefiting creditor the right to recover on the secured debt only up to the point that its claim against the debtor is satisfied. Thereafter, any surplus would have to be paid over to the subordinating creditor. In either event, the assignment would fall within the scope of the PPSA and would need to be perfected by registration.

The contracting parties may, through the use of appropriate drafting, achieve any of these three options. Unfortunately, the language that is used in most security interest subordination provisions does not clearly indicate which of the three possibilities has been chosen. The agreement will simply provide that the security interest of one of the parties is subordinated and postponed to or ranks behind that of another party. It therefore falls to the courts to determine the legal effect of this provision.

2. Legal Issues

Security interest subordination agreements give rise to the following legal issues:

- What is the status of the benefiting creditor's security interest in a bankruptcy of the debtor when the subordinating creditor has perfected its security interest, but the benefiting creditor has not done so?
- What is the ranking of the status of the benefiting creditor's security interest when there is an intervening secured party who ranks ahead of the benefiting creditor but behind the subordinating creditor?
- In the event of a dual bankruptcy of both the debtor and the

103. R.M. Goode, *Legal Problems of Credit and Security*, 3rd ed. (London, Sweet & Maxwell, 2003) at pp. 25-27. It would, however, be possible to create a separate personal obligation on the part of the assignee to pay the value of any surplus to the assignor.

subordinating creditor, what is the status of the benefiting creditor's claim under a subordination agreement in the bankruptcy of the subordinating creditor?

- What is the status of the benefiting creditor's claim under a subordination agreement when the subordinating creditor subsequently assigns its security interest to another creditor?
- What is the status of the benefiting creditor's claim under a subordination agreement where the subordinating creditor subsequently subordinates its security interest to another creditor?

3. Lack of Perfection of the Benefiting Creditor's Security Interest

Consider the following scenario. A debtor gives SP1 and SP2 security interests in the same collateral. SP1 later subordinates its security interest to that of SP2. SP2 improperly registers a financing statement or allows its registration to lapse so as to cause its security interest to become unperfected. The debtor then goes into bankruptcy. SP1's perfected security interest has priority over the trustee in bankruptcy; however, SP2's unperfected security interest is not effective against the trustee in bankruptcy.

If the subordination agreement were simply a promise by SP1 not to enforce its security interest until the claim of SP2 were satisfied, it would provide no basis on which SP2 could assert priority over the trustee in bankruptcy. SP2 would be able to avail itself of SP1's priority if the subordination agreement were to impose a contractual obligation on SP1 to account to SP2 for the value obtained from the enforcement of its security interest or if there were an assignment of SP1's claim to SP2. Canadian cases have clearly taken the view that SP1 is required to account to SP2 for this value.

In *Re Grove Packaging Inc.*,[104] First Ontario subordinated its security interest to that of ORIX. ORIX failed to amend its registration following an amalgamation with the result that its security interest became unperfected. First Ontario's security interest was properly perfected. The debtor (Grove) subsequently went bankrupt. Justice Farley held that "First Ontario is subordinated to and must account to ORIX for any proceeds that it receives as a secured creditor of Grove, such accounting to be to the extent of the interest as to which it is subordinated to ORIX."[105] In turn, First Ontario was entitled to be

104. (2001), 31 C.B.R. (4th) 37, 111 A.C.W.S. (3d) 610 (Ont. S.C.J. (Comm. List)), affd 36 C.B.R. (4th) 57, 116 A.C.W.S. (3d) 451 (C.A.).

subrogated to any amount ORIX received as unsecured creditor in the bankruptcy. Justice Farley indicated that First Ontario could have chosen to protect itself from loss in this situation by providing that the subordination was only effective if the benefiting creditor had properly perfected its security interest or by independently ensuring that there had been an effective registration.

In *Bank of Montreal v. Dynex Petroleum Ltd.*,[106] a secured party subordinated its claim to an unsecured creditor. The debtor then went into bankruptcy. The court held that the subordination was effective in the bankruptcy of the debtor and that the subordinating creditor was required to hold the proceeds in trust for the benefiting creditor up to the amount due.

4. Intervening Secured Claims

Consider a second scenario. Suppose that SP1 registers first, SP2 registers second and SP3 registers third. The order of priorities pursuant to the general priority rule of the PPSA is: (1) SP1; (2) SP2; and (3) SP3. SP1 agrees to subordinate its claim in favour of SP3. This produces an apparent circular priority system. SP1 has priority over SP2 because of SP1's earlier registration. SP2 has priority over SP3, because of SP2's earlier registration; but SP3 has priority over SP1, because of the subordination agreement.

Canadian courts have resolved the apparent circular priority system by finding that SP1 is required to surrender the benefit of its security interest to SP3. First, the amount of SP1's claim is set aside out of the fund. Second, the fund is used to satisfy SP3's claim. If there is anything left over, it is paid to SP1. Third, SP2's claim is satisfied out of the fund. Fourth, any remaining balance is distributed to SP3 and then to SP1. The obligation on the part of the subordinating creditor to account to the benefiting creditor was expressly recognized by the Newfoundland and Labrador Court of Appeal in *General Motors Acceptance Corporation of Canada Limited v. Royal Bank of Canada*.[107]

This outcome would not prevail if the subordination provision were interpreted to be a mere promise to refrain from enforcement until SP3 is fully paid. A mere promise not to enforce is tantamount to

105. *Ibid.*, at para. 5.

106. (1997), 145 D.L.R. (4th) 499, 46 C.B.R. (3d) 36 (Alta. Q.B.), revd on other grounds 182 D.L.R. (4th) 640, 15 C.B.R. (4th) 5 (C.A.).

107. (2006), 24 C.B.R. (5th) 1 *sub. nom. Hickman Equipment (1985) Ltd. (Re)*, 274 D.L.R. (4th) 372 (Nfld. & Lab. C.A.), leave to appeal to S.C.C. refused 275 D.L.R. (4th) vii, [2007] 1 S.C.R. ix.

an agreement to step aside until the benefiting creditor is able to satisfy its claim through the enforcement of its own remedies.[108] This would produce a complete subordination of SP1's claim to both SP2 and SP3, because SP1 would have no right to enforce until SP3's claim was satisfied and this could occur until SP2 was fully paid.

5. The Benefiting Creditor's Claim on a Bankruptcy of the Subordinating Creditor

The Canadian decisions examined earlier recognize an obligation on the part of the subordinating creditor to account to the benefiting creditor. They cannot be reconciled with the view that a subordination provision merely involves a promise not to enforce the security interest. If that were the case, the security interest of the benefiting creditor would have to stand or fall on its own merits, and the benefiting creditor would not be able to obtain the benefit of the subordinating creditor's priority against other competing parties.

The existence of an obligation to account does not tell us whether or not the transaction gives the benefiting creditor a proprietary right in the subordinating creditor's assets. The obligation may be created by contract[109] or it may arise by virtue of a breach of trust.[110] Therefore, further inquiry is needed. This issue becomes relevant when there is a double bankruptcy of both the debtor and the subordinating creditor. Where there is simply a personal obligation to account, the benefiting creditor has merely a claim for contractual damages provable in the bankruptcy of the subordinating creditor and must share with the other unsecured creditors. But where the benefiting creditor has a proprietary right in the secured debt, its claim will be effective against the subordinating creditor's trustee in

108. An agreement not to assert a claim until the other party's claim has been satisfied is sometimes referred to as a complete subordination. It can be contrasted with a partial subordination, under which the subordinating creditor agrees to turn over the benefit of its priority to another party. The difference is that in the former, SP2 is the indirect beneficiary of the subordination between SP1 and SP3. This occurs because SP1 promises not to enforce until SP3 is satisfied, and this cannot occur until SP2's claim is first satisfied. In the latter, SP1 agrees to turn over the benefit of its priority to SP3. SP3 is thereby able to obtain the benefit of SP1's priority over SP2. See R.J. Wood, "Circular Priorities in Secured Transactions Law" (forthcoming in the Alberta Law Review). See also *C.I.F. Furniture Ltd. (Re)* (2010), 183 A.C.W.S. (3d) 910, 2010 ONSC 505 (Comm. List), at para. 51, in which the court indicated that it will not be inclined to characterize an agreement as a complete subordination unless the parties use clear and explicit language to effect this result.

109. Goode, *Commercial Law, supra*, footnote 24, at p. 615.

110. See R. Chambers, "*Liability*" in P. Birks and A. Pretto, eds., ***Breach of Trust*** (Oxford, Hart Publishing, 2002), at pp. 16-20.

bankruptcy subject to any perfection requirements imposed by the PPSA.

Some commentators have argued that a security interest subordination involves a transfer of a proprietary right.[111] They argue that because the subordination involves only a partial waiver of the security interest — it is waived in respect of the benefiting creditor, but is not waived in respect of anyone else — there must be a transfer of the subordinating creditor's interest to the benefiting creditor. This ignores the possibility that the subordinating creditor is not transferring its secured debt, but is instead undertaking a personal obligation to pay its value up to the limit of the benefiting creditor's claim when it is enforced against other claimants.

In *Bank of Montreal v. Dynex Petroleum Ltd.*,[112] the court held that "[a] subordination agreement does not, by virtue of the subordination alone, and in the absence of specific language to that effect, create a security interest in favour of the beneficiary of the subordination." This appears to reject the view that a subordination provision gives the benefiting creditor a proprietary right in the secured debt held by the subordinating creditor. The court, however, also stated that the subordinating creditor is required to hold the proceeds in trust for the benefiting creditor up to the value of the benefiting creditor's claim. This seems to support the view that a security interest subordination gives the benefiting creditor a proprietary right in the secured debt. Given these conflicting statements, one must conclude that the case does not provide an authoritative answer to this question.

In *Re C.I.F. Furniture*,[113] Morawetz J. held that the effect of an intercreditor subordination agreement was that the subordinating creditor was required to set aside a portion of the funds it received in trust to be paid to the benefiting creditor. Like the previous decision, it is questionable whether it should be considered authoritative on this particular issue. Neither of these cases involved a bankruptcy of the subordinating creditor and it was unnecessary for the court to decide whether the obligation to account involved only a promise to pay a sum of money to the other party (a personal right) or whether it involved the transfer of an interest in the fund to the benefiting creditor (a proprietary right). Courts may, therefore, wish to revisit this particular issue in future decisions when the outcome of the case turns on how this obligation is to be characterized.

111. See Coogan, Kripke and Weiss, *supra*, footnote 59, at pp. 259-260.

112. *Supra*, footnote 106, at para. 61.

113. *Supra*, footnote 108.

There are two reasons why it would be better to adopt the view that a security interest subordination provision imposes only a personal obligation to account and does not transfer a proprietary right in the secured debt. First, commercial certainty would be weakened if courts were too quick to recognize the creation of property rights through implication. The parties to a subordination agreement are free to create a security interest by providing for an assignment of the subordinating creditor's security interest or by including a provision that requires the subordinating creditor to hold the funds in trust for the benefiting creditor. If they wished to enjoy the benefits of this feature, they would have to include express language in the agreement to achieve it.[114] The legislative drafters of the British Columbia, Saskatchewan, the Northwest Territories and Nunavut PPSAs were clearly influenced by this view. A court is required to find that subordination of a security interest does not of itself create a security interest, unless some additional element is present to show that a security interest was intended.[115]

Second, this view promotes greater uniformity in Canadian secured transaction law. Consider the outcome if the contrary view were accepted. In provinces that adopt the British Columbia approach, a standard subordination clause would only give the creditor the right to prove a claim in the bankruptcy. The benefiting creditor, like any other contracting party who did not obtain a proprietary right in the bankrupt's assets, would take the risk of the subordinating creditor's bankruptcy. In order to protect itself against this risk, it would be necessary for the benefiting creditor to expressly create a security interest and register it pursuant to the PPSA. But in provinces that did not adopt this model, a standard security interest subordination clause would always create a security interest and it would be effective against the trustee in bankruptcy as long as it was properly perfected. If it were accepted that a bare subordination does not create a security interest, then the position would be the same in all Canadian jurisdictions. The subordination alone will not create a security interest in the secured debt of the subordinating creditor, but it is open for the parties to create a security interest by including additional language that manifests such an intention.

Assuming that the parties to the subordination agreement include additional language that transfers an interest in the secured debt of the subordinating creditor, one further observation should be made concerning the method of perfection. The PPSA permits registration of

114. See MacDougall, *supra*, footnote 11, at pp. 268-269.
115. See Cuming, Walsh and Wood, *supra*, footnote 6, at pp. 88-89.

a financing change statement disclosing a subordination agreement.[116] This is not sufficient to perfect a security interest in the subordinating creditor's secured debt. The transaction effectively withdraws a valuable asset from the estate of the subordinating creditor's trustee in bankruptcy and, therefore, it is registration against the name of the subordinating creditor (rather than against the name of the common debtor) that is needed to perfect the security interest.

6. Assignment of the Security Interest by the Subordinating Creditor

The nature of the benefiting creditor's claim against the subordinating creditor is also relevant where the subordinating creditor subsequently assigns the secured debt. If the subordination agreement were to create only a personal obligation, then the assignee would acquire the secured debt free of any claim of the befitting creditor. But if the subordination agreement were to transfer a proprietary interest in the secured debt to the benefiting creditor, then the benefiting creditor would be able to claim a security interest in it. A competition between the benefiting creditor and the subsequent assignee would be resolved using the ordinary priority rule of the PPSA and priority would generally be given to the first to register a financing statement.

7. Successive Subordinations

A secured party may enter into a subordination agreement with A and later enter into another subordination agreement with B. This would pose no difficulty in the case of a contractual or step-aside subordination provision, since the successive subordinations would not be inconsistent and the subordinating creditor would simply be relegated to the back of the priority queue behind both parties. The usual form of security interest subordination provision, however, carries with it a promise to account to the other creditors for any value received. This would mean that both A and B would have a personal right to bring an action against the subordinating creditor. If the subordination agreement in favour of B created a proprietary interest in the secured debt, B would be able to assert an interest in the secured debt free of the mere personal claim of A. If both subordination agreements created a proprietary interest in the secured debt, then the

116. OPPSA, s. 50; APPSA, s. 45(6).

priority competition would be resolved by the usual first to register rule of the PPSA.

VI. CONCLUSION

Although subordination agreements are widely used, they are not as comprehensively understood. Are they effective in a bankruptcy? Do they need to be registered under the PPSA? How are disputes to be resolved where the subordinating creditor assigns the junior debt or security interest to another person, or enters into a second subordination with another creditor?

The key to resolving these issues is to determine the nature of the rights created by the agreement. Here, the fundamental distinction between personal rights and proprietary rights is of central importance. A promise by a junior or subordinating creditor not to enforce its claim gives the senior or benefiting creditor only a personal right against that party. A promise to pay the senior or benefiting creditor a sum equivalent to that received by way payment, enforcement or distribution likewise gives rise only to a personal right. This will not give the recipient a proprietary right to the debt that can be asserted against the junior or subordinating creditor's trustee in bankruptcy or against a subsequent assignee of the debt. But where the subordination agreement transfers the junior or subordinating creditor's claim to the recipient, it confers a proprietary right. This must be perfected under the PPSA in order render it effective against the junior or subordinating creditor's trustee in bankruptcy or in a competition with a subsequent assignee of the debt.