BANK ACT – PPSA INTERACTION: STILL WAITING FOR SOLUTIONS

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I. INTRODUCTION

One is right to suspect that something is seriously amiss when leading commercial law scholars use language such as "Once More into the Black Hole"[1] and "No Closer to Solutions"[2] in the titles of their work. These pieces deal with the tortured and dysfunctional relationship between the federal Bank Act[3] security system and the provincial Personal Property Security Act (PPSA) regimes.[4] It is a problem that has plagued us for a long time.[5] There has been a recent burst of activity — two Supreme Court of Canada decisions[6] and then, following close on their heels, a federal legislative response in a bill that will enact the Financial System Review Act.[7] Rather than fixing the problem, regretfully, we find ourselves once more in a black hole and still no closer to solutions.

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1. J.S. Ziegel, "The Interaction of Section 178 Security Interests and Provincial PPSA Security Interests – Once More into the Black Hole" (1991), 6 B.F.L.R. 343.
2. R.C.C. Cuming, "PPSA Section 178 Bank Act Overlap: No Closer to Solutions" (1991), 18 C.B.L.J. 135.
3. S.C. 1991, c. 46.
4. The Alberta Personal Property Security Act, R.S.A. 2000, c. P-7 (APPSA) and the Ontario Personal Property Security Act, R.S.O. 1990, c. P.10 (OPPSA) will be used to represent the two models of PPSA found in Canada. Most of the common law provinces adhere to the same model as the APPSA (they are all based on the model developed by the Canadian Conference on Personal Property Security Law (CCPPSL)).
5. *Rogerson Lumber Co. v. Four Seasons Chalet Ltd.* (1980), 29 O.R. (2d) 193 (C.A.) was one of the earliest decisions to examine the issue.
6. *Innovation Credit Union v. Bank of Montreal*, 2010 SCC 47; *Radius Credit Union Ltd. v. Royal Bank of Canada*, 2010 SCC 48.
7. An Act to Amend the Law Governing Financial Institutions and to Provide for Related and Consequential Matters, 1st Sess., 41st Parl. (2011). At the time of writing, the bill had received third reading in the Senate, second reading in the House of Commons and had been referred to the Finance Committee.

I will demonstrate that this latest legislative solution is wholly inadequate. The new priority rule fails to confront the fundamental root of the problem: the fact that the priority mechanisms of the two regimes are based on two radically different ideas. It is a band-aid solution that does not resolve the lack of compatibility between the two systems, but which will produce new interpretive problems and generate more litigation. As a consequence, many of the significant transactional efficiencies introduced by the modernization of provincial secured transactions law are severely compromised. This latest legislative intervention has therefore made an even greater mess of an already badly muddled situation.

II. THE NATURE OF THE PROBLEM

The federal Bank Act security system and the pre-PPSA provincial secured transactions regimes took the same basic approach to the resolution of priority competitions. Priorities were not determined by the order of registration. Instead, they were resolved through application of common law principles that determined disputes between competing proprietary interests. The statutes imposed a registration requirement, but a failure to register had merely a negative effect in that it rendered the interest ineffective against subsequent parties who did not know of the unregistered interest. The Bank Act system introduced some important features that were later adopted in the PPSA, such as notice registration as opposed to document registration.[8] But the Bank Act security system was quite unlike the PPSA in that it did not embrace a first to register or perfect rule of priority.

The absence of a common conceptual basis for the resolution of priorities between a PPSA security interest and a Bank Act security created a series of difficulties that courts have been struggling with over the past three decades.[9] The approach that has been adopted in most jurisdictions proceeds from the premise that the PPSA priority rules have no application in a dispute between a PPSA security interest and a Bank Act security.[10] Instead, the priority

8. Bank Act, s. 427(4) and (5).
9. See R.C.C. Cuming and R.J. Wood, "Compatibility of Federal and Provincial Personal Property Security Law" (1986), 65 Can. Bar Rev. 267 for a more extensive discussion of these problems.
10. See *Royal Bank of Canada v. Agricultural Credit Corp. of Saskatchewan* (1994), 115 D.L.R. (4th) 569 (Sask. C.A.). And see *Innovation Credit Union v. Bank of Montreal, supra*, footnote 6, at paras. 27-30. The situation in Ontario is more complex because the Ontario PPSA does not exclude a Bank Act security from its

competition is to be determined by applying the provisions of the Bank Act. The Bank Act contains an express priority rule that gives the bank priority over subsequently created interests.[11] Although the Bank Act does not contain an express priority rule that deals with competitions with prior interests, this can be derived from other provisions that give the bank the same right and title as that held by the debtor.[12] Through this mechanism, the Bank Act replicates the common law rule of *nemo dat quod non habet*.[13]

This produces a number of difficulties. Because the PPSA priority rules are not engaged, a lack of registration or perfection of a prior PPSA security interest did not result in its subordination to a subsequent Bank Act security.[14] The PPSA concept of a purchase money security interest (PMSI) and its enhanced priority status are also inapplicable for the same reason. The priority of a PMSI financer therefore is to be determined by applying the *nemo dat* approach. This result is that only seller-based PMSIs that involve a retention of title are recognized (regardless of whether they were registered or otherwise perfected).[15] Lender-based PMSIs are subordinate on the basis that they fall squarely within the Bank Act priority rule that confers priority to the bank over subsequent interests.[16]

III. A SHORT HISTORY OF REFORM EFFECTS

In order to understand the proposed amendment it is useful to look at past attempts at legislative reform. An examination of these efforts permits us to identify both the nature of the problems

scope. See *Bank of Nova Scotia v. International Harvester Credit Corp. of Canada Ltd.* (1990), 74 O.R. (2d) 738 (Ont. C.A.).

11. Bank Act, s. 428(1).
12. *Ibid.*, ss. 427(2) and 435(2).
13. See *Innovation Credit Union v. Bank of Montreal*, *supra*, footnote 6, at para. 51.
14. *Ibid.*
15. *Kawai Canada Music Ltd. v. Encore Music Ltd.* (1993), 101 D.L.R. (4th) 1 (Alta. C.A.), reconsideration/rehearing refused 103 D.L.R. (4th) 126, leave to appeal to S.C.C. refused 104 D.L.R. (4th) vii; *Yamaha Motor Canada Ltd. v. 406248 B.C. Ltd.* (1998), 39 B.L.R. (2d) 130 (B.C.S.C.), at para. 33.
16. See *Royal Bank of Canada v. Moosomin Credit Union*, 2003 SKCA 115, leave to appeal to S.C.C. refused [2004] 1 S.C.R. xii. Although a purchase money priority in favour of a lender was possible at common law under certain circumstances, the court appears to reject this possibility in the context of the Bank Act security. See R.C.C. Cuming, C. Walsh and R.J. Wood, *Personal Property Security Law* (Toronto, Irwin Law, 2005), pp. 591-592.

and the different types of solutions that have been proposed or implemented.

1. The PPSA Provisions

The co-existence of both a federal and a provincial personal property security system creates two sorts of issues. The first arises when a Bank Act security comes into competition with a PPSA security interest as it is necessary to determine their priority ranking (the priority issue). The second comes about when a bank obtains a Bank Act security as well as a PPSA security interest in the same collateral to secure the same obligation (the dual documentation issue). There are provincial legislative provisions that touch on both these matters, but the approach is neither uniform nor comprehensive.

A crucial question on the priority issue concerns the application of the PPSA priority rules. Are they of any relevance? The OPPSA does not specifically include or exclude Bank Act security from the scope of its provisions. This issue eventually came before the Ontario Court of Appeal.[17] The court held that the OPPSA definition of a security interest was wide enough to cover a Bank Act security. This produces a considerable degree of complexity in the determination of priorities, since a bank that has taken Bank Act security may assert priorities under both the PPSA and the Bank Act.[18] The PPSAs of other provinces specifically provide that the Act does not apply to a Bank Act security.[19] This simplifies matters in that priorities between a Bank Act security and a PPSA security interest are to be determined without regard to the priority rules of the PPSA. However, it does not result in a satisfactory

17. *Bank of Nova Scotia v. International Harvester Credit Corp. of Canada Ltd.*, *supra*, footnote 10. And see Ziegel, *supra*, footnote 1; Cuming, *supra*, footnote 2; and R.J. Wood, "The Nature and Definition of Federal Security Interests" (2000), 34 C.B.L.J. 65, at pp. 78-81 for a discussion of this decision.

18. The competition was between a prior unperfected provincial security interest and a subsequent Bank Act security that was registered in both the provincial and federal registries. Although the Bank Act security fell within the PPSA definition of a security interest, this did not permit the bank to obtain the benefit of the first to register rule of priority. Because the Bank Act security document only gave the bank the interest that the debtor had in the collateral, the bank could only assert a claim to the debtor's equity in the collateral and was therefore subordinate to the prior unregistered encumbrance.

19. See APPSA, s. 4(b), which excludes "a security agreement governed by an Act of the Parliament of Canada that deals with rights of parties to the agreement or the rights of third parties affected by a security interest created by the agreement, and any agreement governed by sections 425 to 436 of the *Bank Act* (Canada)."

solution since the Bank Act provisions are not properly co-ordinated with the PPSA systems.

On the dual documentation issue, Saskatchewan is the only jurisdiction that has attempted to regulate this matter. The Saskatchewan PPSA provides that a security interest ceases to be valid with respect to collateral for so long as the security interest secures an obligation that is also secured by a Bank Act security.[20] A bank therefore cannot assert rights under both the PPSA and the Bank Act on the same collateral to secure the same obligation. If a bank chooses to take a Bank Act security, any PPSA security interest loses its validity until the Bank Act security is discharged. In the other jurisdictions, the position is less clear. The courts will likely require the secured party at some point to make an election, but the mere registration of the security interest does not constitute an election.[21]

2. The Department of Finance Position Paper

In 1991, the Department of Finance released its *Position Paper on Revising Bank Act Security*.[22] The paper proposed a major revision of the Bank Act security device by importing many of the fundamental concepts that are found in provincial PPSAs. The scope of the federal regime would be greatly expanded to cover all types of debtors and all types of collateral, including consumer goods. Banks would be prohibited from using the provincial PPSAs. Security interests given to a bank would be governed by the reformed federal system, while non-bank creditors would use the provincial system.

The position paper received a frosty reception.[23] The expanded scope of the federal system would significantly increase the

20. Personal Property Security Act, 1993, S.S. 1993, c P-6.2, s. 9(2) provides that a PPSA security interest "ceases to be valid . . . to the extent that and for so long as the security interest secures" an obligation that is also secured by a Bank Act security. The original version provided that the PPSA security interest was "void" to the extent that it covered such obligations. This was changed in light of difficulties that were encountered when branches of a Saskatchewan credit union were transferred to a bank in order to ensure the continuation of financial services in rural communities. See Saskatchewan, *Official Report of Debates of the Legislative Assembly* (*Hansard*) (May 26, 2000), p. 1370. The new language permits the bank to elect the Bank Act security by waiving its rights under its PPSA security interest.

21. See *Kassian v. National Bank of Canada* (1998), 61 Alta. L.R. (3d) 92 (Q.B.), affd 73 Alta. L.R. (3d) 56 (C.A.).

22. D. Tay, R. Chartrand, B. Goldberg and C. Hansell (Ottawa, Department of Finance, January 1991).

problem of dual searches, as it would be necessary to conduct a search of both the federal and provincial registries in every case.[24] More significantly, the proposal would have the effect of seriously undermining the economic viability of the provincial registries as there would be a drastic reduction in the registration volumes which would critically reduce the registration fee revenues that are used to maintain the systems.[25] The Canadian Bar Association – Ontario made a submission that recommended against the proposed revision.[26] It acknowledged that a "single, computer based Canada-wide personal property security registration system available for use by all secured parties (including banks) would have great merit," but noted that the proposal would not achieve this outcome. Moreover, the position paper failed to articulate precisely how priority competitions between provincial and federal security interests were to be resolved.[27] This initiative was therefore abandoned for lack of support.

3. The CCCPSL/CBA Working Group Proposal

From 1995 to 1996, the Canadian Conference on Personal Property Security Law (CCPPSL) and the Canadian Bankers' Association (CBA) struck a working group to investigate whether a mutually acceptable solution could be found. The Working Group proposal was relatively modest in its objectives. It did not attempt to change the substantive features of the Bank Act security so as to bring it closer to those of PPSA security interests. Nor did it attempt to create a single registry system. The strategy was simply to design a set of priority rules that would resolve competitions between PPSA security interests and Bank Act security.

Priorities were to be determined on the basis of a first to register rule of priority, although the registrations would not occur in the same registry. If the PPSA security interest was registered in the provincial registry before a bank registered a Bank Act security interest in the federal registry, the PPSA security interest would rank first in priority. But if the Bank Act security was registered before

23. See R.C.C. Cuming, "The Position Paper on Revised Bank Act Security: Rehabilitation of Canadian Personal Property Security Law or Curing the Illness by Killing the Patient" (1992), 20 C.B.L.J. 336.
24. *Ibid.*, at p. 353.
25. *Ibid.*, at p. 347.
26. Personal Property Security Law Committee, *Submission on the Position Paper on Revising Bank Act Security* (February 25, 1992).
27. *Ibid.*, at p. 4.

the PPSA security interest was registered, the Bank Act security would prevail. An exception was made for subsequent provincial PMSIs. These would be given priority so long as they complied with the procedural requirements of the PPSA. In the case of inventory, the superpriority would be available only if a notice was given to the bank that had an earlier registration in the Bank Act registry. The bank's right to claim proceeds was also expressly recognized, subject to its being overridden by the same range of interests as applicable to perfected security interests under provincial law.[28]

The Department of Finance had indicated that it was not prepared to introduce amendments unless all the PPSA jurisdictions agreed in principle to the proposal.[29] The initiative came to an abrupt standstill when the PPSA Committee of the Canadian Bar Association – Ontario decided against giving its endorsement.[30] In its opinion, the Working Group proposal offered only a "band-aid solution"[31] that did not eliminate the problems associated with dual registries. Moreover, it created additional burdens on inventory financers as they would be required to search both registries and provide PMSI notices to two sets of prior registrations.[32] With this, the second attempt for a solution thereupon abruptly ground to a halt.

4. The Law Commission of Canada Report

In 2004, the Law Commission of Canada issued its *Report on Modernizing Canada's Secured Transactions Law: The Bank Act Security Provision*.[33] The Report identified three possible avenues for reform.[34] The first was to amend the Bank Act security provisions in order to eliminate the priority problems that arise when the two systems come into contact with one another. The second was to replace the current Bank Act security system with a

28. The basic attributes of the proposal are summarized in Canadian Bar Association – Ontario, *Harmonization of Section 427 of the Bank Act and the Provincial Personal Property Security Acts* (Ottawa, April 7, 1997) at pp. 5-6.
29. *Ibid.*, at p. 7.
30. *Ibid.*, at p. 12. The CBAO offered its preferred solution in the form of a legislative suspension of the Bank Act security provisions in those provinces that have enacted a PPSA and that do not discriminate against banks. Given the time frames required for reaching a legislative amendment, the lack of agreement as to the appropriate avenue for reform effectively killed the initiative.
31. *Ibid.*, at p. 9.
32. *Ibid.*, at p. 8.
33. (Ottawa, 2004).
34. *Ibid.*, at pp. 23-30.

modernized federal personal property security system based on the same language and concepts as the provincial systems. The third was to repeal the Bank Act security system.

The Law Commission of Canada thought that repeal of the Bank Act security provisions was the preferred solution. The other two options did not eliminate the problem of dual registry searches. As well, the difficulties in harmonizing the federal and provincial systems were compounded by the fact that the reformed system would need to interact with both the common law and civil law secured transactions regimes. The repeal of the Bank Act provisions was the only option that eliminated the dual registry problem. It also would create a fairer system in that bank and non-bank lenders would operate under the same rules. The Law Commission of Canada was of the view that the modernization of all of the provincial and territorial secured transactions regimes had rendered unnecessary any further federal presence in the field. The banks were very familiar with the provincial systems and usually regarded it as their principle security device. The argument that the Bank Act security provisions were desirable because they permitted banks to avoid provincial limitations on the exercise of secured creditor remedies was rejected on the basis that it simply gave one class of lenders — banks — an unwarranted advantage over non-bank lenders and thereby produced distortions in the credit market.

The Department of Justice considered the Report as part of its 2006 financial services review. The recommendation to abolish the Bank Act security provisions were vigorously opposed by the Canadian Banker's Association.[35] Their submission argued for the retention of the Bank Act security regime on the basis that it alone provided a national regime. It also claimed that uncertainty associated with priority competitions had been largely resolved by the courts and that PMSI lenders could obtain waivers or priority agreements from the banks in order to ensure that they would have priority. The federal government chose not to act on the recommendations of the Law Commission of Canada, the Uniform Law Conference of Canada[36] and the Canadian Bar

35. See *The 2006 Financial Institutions Legislation Review: Improving the Legislative Framework for Canadian Consumers*, Canadian Bankers Association submission to the Government of Canada (Toronto, June 1, 2005), at pp. 111-112, online: <http://www.fin.gc.ca/consultresp/06Rev_37e.pdf>.

36. The Civil Section Minutes of the 2003 Uniform Law Conference of Canada indicate that the Conference passed a resolution that the President of the Conference should write the federal Ministers of Justice, Finance and Industry

Association,[37] and in a very short and unpersuasive explanation stated that to do so "would mean that banks would lose the benefit of a national regime, potentially reducing their security rights."[38]

IV. THE *INNOVATION* AND *RADIUS* DECISIONS

In 2010, the Supreme Court of Canada released two decisions concerning the interaction between a Bank Act security and a PPSA security interest. In *Innovation Credit Union v. Bank of Montreal*,[39] the competition was between an earlier unperfected PPSA security interest and a subsequent Bank Act security. The court held that the lack of perfection of the PPSA security interest did not result in its subordination to the later Bank Act security. The priority competition was to be determined by applying the Bank Act priority rules. The Bank Act provides that a bank can acquire no greater interest in the collateral than the debtor. In this respect, it replicates the *nemo dat* principle of the common law, which ranks interests according to the time of their creation.[40]

Although some commentators expressed surprise at the decision,[41] it really did no more than confirm the prior case law.[42] This outcome was identified as a major problem by the Law

recommending repeal of the provisions of the Bank Act, which create a separate regime for security interests in personal property. See Uniform Law Conference of Canada, online: <http://www.ulcc.ca/en/poam2/index.cfm?sec=2003&-sub=2003f>.

37. The Canadian Bar Association wrote to the Department of Finance on June 30, 2006 recommending the repeal of the Bank Act security provisions, and wrote again in December 9, 2010 reiterating its view that the provisions should be repealed. See online: <http://www.cba.org/cba/submissions/pdf/10-80-eng.pdf>.

38. See "2006 Financial Institutions Legislation Review: Proposals for an Effective and Efficient Financial Services Framework" (Ottawa, Department of Finance Canada, 2006), at p. 15, online: <http://www.collectionscanada.gc.ca/webarchives/20071123141035/http://www.fin.gc.ca/activty/pubs/white06e.pdf>. And see J.S. Ziegel, "Ottawa Rejects Reform of Section 427 of the Bank Act" (2007), 45 C.B.L.J. 123 for a critique of the federal government's response.

39. *Supra*, footnote 6.

40. *Ibid.*, at para. 51.

41. See B. Crawford, "In Defence of Secret Liens: or, How the Supreme Court Presses Parliament to Harmonize Section 427 of the Bank Act with the PPSA's" (2011), 26 B.F.L.R. 305, at p. 308. See also R.M. Scavone and A Mirza, "Bill S-5 (Financial System Review Act) will restore priority of bank act security over unperfected PPSA security interests" (Toronto, McMillan, December, 2011), online: <http://www.mcmillan.ca/Bill-S-5-Financial-System-Review-Act-will-restore-priority-of-bank-act-security-over-unperfected-PPSA-security-interests>.

42. This position was first developed in the decision in *Rogerson Lumber Co. v. Four Seasons Chalet Ltd.*, *supra*, footnote 5, and later confirmed in *Bank of Nova Scotia v. International Harvester Credit Corp. of Canada Ltd.*, *supra*, footnote 10.

Commission of Canada,[43] and the Supreme Court of Canada was clearly sympathetic to the view that some form of legislative response was desirable.[44] However, the idea that legislation was needed to overturn a new and unexpected development in the case law simply cannot be supported.

In *Radius Credit Union Ltd. v. Royal Bank of Canada*,[45] the competition was similar to *Innovation* except in one respect. The competition was in respect of after-acquired assets that were acquired by the debtor after both the security agreements had been signed. The court held that this did not make any difference to the outcome. The court held that both the bank and the credit union held an existing but inchoate security interest until the debtor acquired the new asset.[46] Because the credit union's security interest arose first, the bank's security took subject to it.

V. THE BANK ACT AMENDMENTS

The amendments to the Bank Act security regime will be introduced by the Financial System Review Act[47] as part of the 2012 Financial Institutions Legislation Review.

1. The New Priority Rule

Section 428(1) of the Bank Act provides that a bank that has been given Bank Act security has priority over all rights subsequently acquired in the property. The priority provision will be amended so as to extend its reach. A bank continues to enjoy priority over a subsequent interest, but will now also obtain priority over "any person who has a security interest in that property that was unperfected at the time the bank acquired its security in the property." The bank cannot claim this priority if the bank knew of the unperfected security interest at the time the bank acquired its security.[48]

Section 425(1) of the Bank Act will be amended by the inclusion of the following definition:

> "unperfected", in relation to a security interest, means that the security interest has not been registered in a public register maintained under the law

43. *Supra*, footnote 33, pp. 12-13.
44. *Innovation Credit Union v. Bank of Montreal*, *supra*, footnote 6, at para. 1.
45. *Supra*, footnote 6.
46. *Ibid.*, at para. 19.
47. *Supra*, footnote 7.
48. Bank Act, s. 428(2).

> under which the security interest is created, or has not been perfected or published by any other means recognized by that law, where the registration or other means of perfection or publication would have made the security interest effective against third parties or would have determined priorities in rank in respect of rights in, on or in respect of the property that is subject to the security interest.

A definition of "security interest" is found in s. 2 of the Bank Act. It is worded as follows:

> *"security interest"* means an interest in or charge on property by way of mortgage, lien, pledge or otherwise taken by a creditor or guarantor to secure the payment or performance of an obligation.

This definition is not new. It was used in other provisions of the Bank Act that did not relate to Bank Act security, but now is relevant because of the use of the term in the amended provisions.

On first reading, the provisions seem relatively straight-forward and unproblematic. A bank that takes Bank Act security will enjoy priority over a prior unperfected PPSA security interest unless the bank knows of the security interest. But on deeper investigation, it becomes apparent that matters are not so simple. There are two problems. First, the language that is used creates significant interpretive difficulties. Second, the new priority rule continues to rely upon a *nemo dat* philosophy for the resolution of priority competitions and thereby undermines many of the important commercial law policies found in the PPSA.

2. Interpretive Problems

There are three interpretive difficulties associated with the new provisions. The first concerns the timing element. The bank is given priority over any person who has an unperfected security interest "at the time the bank acquired its security in the property."[49] This is quite different from the first to register or perfect rule of priority found in the PPSA. Unlike a competition between two PPSA security interests, a subsequent lapse or discharge of a registration of the earlier registration will not affect priorities. The priority competition is determined at a particular point in time — when the bank acquires its security in the property.

This might mean one of two things. It might refer to the time when the bank obtains delivery of the security documents signed

49. Bank Act, s. 428(1).

by the debtor. This will certainly be the case in respect of property that is already owned by the debtor. But when does a bank obtain its security when after-acquired property is involved? Is it the date of delivery of the security document to the bank, or is it when the debtor obtains ownership of the new property? The question is important since it determines the point in time for determining if the PPSA security interest is unperfected. Consider a scenario where the PPSA security interest was perfected at the date the bank obtained delivery of the security document but thereafter became unperfected before the debtor acquired new property. If the time for determining perfection is the date of delivery of the security documents, the bank will lose. If it is when the bank obtains rights in the new property, the bank will win.

Two arguments may be made in favour of the time of delivery of the security document as the appropriate date. First, this interpretation is more consistent with the underlying purpose of the priority rule. The problem was that banks had no means of discovering the existence of unperfected security interests at the time they were granted Bank Act security. The expectation is that they will now be able to search the provincial registry to determine if the collateral is subject to a pre-existing security interest before entering into a secured transaction with the debtor. Second, this interpretation is in accord with the view expressed by the Supreme Court of Canada in the *Radius* decision. The court held that a secured creditor may have an "inchoate" interest from the date of the security agreement despite the fact that the debtor has not yet acquired an interest in the after-acquired asset.[50] On this view, a bank "acquires its security" in a future asset when the security document is delivered to the bank.

The second problem concerns the identification of the proper place for registration of the security interest. A bank is given priority over an unperfected security interest. A security interest is unperfected if it has not been registered "under the law under which the security interest is created."[51] The Bank Act provision offers no guidance on how this determination is to be made. The choice of law rules of private international law use the location of the collateral as the connecting factor.[52] Although this is the general rule under the PPSA,[53] in some instances, such as in the case

50. *Supra*, footnote 6, at para. 19.
51. Bank Act, s. 425(1).
52. See Cuming, Walsh and Wood, *supra*, footnote 16, p. 120.
53. APPSA, s. 5; OPPSA, s. 5.

of inherently mobile goods that are held as equipment or lease inventory, the PPSA directs the court to look to the location of the debtor.[54] Will a court apply the choice of law rules contained in the PPSA to answer this question? Or does the federal provision create its own choice of law rule that displaces the PPSA? And if it does, what connecting factor is to be used?

The third interpretive difficulty concerns the definition of "security interest" that is used in the Bank Act. A similar definition is used in the Income Tax Act[55] in relation to the statutory deemed trust[56] and secured charge[57] in favour of the Crown for unremitted source deductions. The courts have held that this formulation does not cover title retention devices such as a conditional sales agreement or a financing lease despite the fact that these transactions are considered to be true security interests for the purpose of the PPSA.[58] The Bank Act definition refers to an interest in or charge on property by way of mortgage, lien, pledge or otherwise taken by a creditor. This language does not encompass title retention devices since the interest is not in the form of a mortgage, charge, lien or pledge and is created through the retention of title rather than by the grant of an interest by the debtor. This would mean that a failure to perfect a conditional sales agreement or a financing lease would not result in a loss of priority to a subsequent bank that took Bank Act security. The new priority provision would not apply because the title retention device does not fall within the federal definition of a security interest.[59]

Even if the definition were interpreted to include title retention devices, the new Bank Act priority rule would still not result in the subordination of a subsequent unperfected PPSA security interest in the form of a title retention device. The title retention device has priority over the prior Bank Act security on the basis that the bank

54. APPSA, s. 7; OPPSA, s. 7.
55. R.S.C. 1985, c. 1 (5th Supp.), s. 224(1.3).
56. *Ibid.*, s. 227(4.1).
57. *Ibid.*, s. 224(1.2).
58. *DaimlerChrysler Financial Services (DEBIS) Canada Inc. v. Mega Pets Ltd.*, 2002 BCCA 242; *M.N.R. v. Schwab Construction Ltd.*, 2002 SKCA 6; *Bank of Nova Scotia v. Turyders Trucking Ltd.* (2001), 32 C.B.R. (4th) 14 (Ont. S.C.J.). See also J.S. Ziegel, "Conditional Sales and Superpriority Crown Claims under ITA s. 227" (2003), 38 C.B.R. (4th) 161.
59. The use of this obsolete pre-PPSA definition of a security interest in the federal insolvency statutes also creates significant problems. See R.J. Wood, "The Definition of Secured Creditor in Insolvency Law" (2010), 25 B.F.L.R. 341 and R.J. Wood, "The Structure of Secured Priorities in Insolvency Law" (2011), 27 B.F.L.R. 25, at pp. 30-34.

only acquires the encumbered interest of the buyer.[60] The new priority rule would not be engaged because it only subordinates an unperfected security interest that is in existence at the time the bank acquired its security. In this case, the unperfected PPSA security interest is not in existence at the time the bank acquires its security, but comes into existence at some later point.

3. Compatibility Problems

Even if one were to pass further amending legislation to clear up these difficulties, this still would not produce a satisfactory solution. The root of the problem is that the two systems are built on a fundamentally different conception of how priorities among secured parties are to be resolved. The PPSA uses a first to register or perfect rule of priority. The Bank Act security adopts the older *nemo dat* philosophy. The latter is given pre-eminence over the former with the result that the usual commercial expectations of secured parties familiar with the PPSA regime are thrown into disarray.

(a) Advance Registration

The PPSA confers priority on the basis of a first to register rather than a first to perfect rule of priority.[61] This is illustrated in the following example. On day one, SP1 registers. On day three, SP2 registers and is granted a security interest in the collateral. On day five, SP1 is granted a security interest in the collateral. SP1's security interest is perfected on day five once it attaches. SP2 is the first to perfect (on day three). Nevertheless, SP1 is given priority under the PPSA. The registration puts other creditors on notice that SP1 is intending to obtain a security interest. SP1 is able to negotiate with the debtor without being concerned about an intervening secured party usurping it in priority.[62] Moreover, it facilitates the rapid closing of the transaction since SP1 can make loan advances immediately to the debtor without concern over a potential loss of priority to an intervening secured party.

The Bank Act does not employ a first to register rule of priority. It adopts a temporal rule based on the order that the interests are created. As a result, SP1 cannot rely upon the advance registration

60. *Kawai Canada Music Ltd., supra*, footnote 15; *Yamaha Motor Canada Ltd. v. 406248 B.C. Ltd., supra*, footnote 15.

61. APPSA, s. 35(1)(a); OPPSA, s. 30(1).

62. See D.G. Baird, "Notice Filing and the Problem of Ostensible Ownership" (1983), 12 J. Legal Studies 53, at p. 63.

facility of the PPSA whenever there is a risk that a bank may be given Bank Act security. In the example, substitute a bank with Bank Act security for SP2. The PPSA priority rule will not apply. Instead, the bank has priority over SP1. The bank wins because its security comes into existence before the PPSA security interest arises. An important feature of the PPSA is thereby nullified. SP1 has no assurance that it will have priority, and cannot safely advance funds until it can verify that no Bank Act security has been granted before attachment of its security interest.

(b) The Relevance of Knowledge

The PPSA has eliminated knowledge as a factor in the resolution of priority competitions between secured parties. This was a deliberate policy choice that was designed to make the determination of priorities more certain and less costly.[63]

This is illustrated in the following example. On day one, SP1 is given a security interest, but fails to register or otherwise perfect it. On day five, SP2 is given a security interest in the same asset and perfects it. SP2 knows of SP1's unperfected security interest at the time it acquires its security interest. Under the PPSA, SP2 ranks ahead of SP1. SP2 is able to ascertain its priority status simply by determining that it has the earlier registration, and does not need to be concerned over whether knowledge of a prior interest will be attributed to it.

Now substitute a bank for SP2. A bank that knows of an unregistered security interest is not given priority over the earlier unperfected security interest. In a competition with a Bank Act security, the outcome will depend upon the state of knowledge of the bank. A costly fact-finding investigation may be required in order to resolve the priority competition.

(c) Public v. Private Information

The PPSA uses a first to register or perfect rule of priority in order to lower the transaction costs and reduce the uncertainty involved in the determination of priorities. The time of creation (attachment) of a security interest plays a relatively minor role in the PPSA priority rules.[64] Using time of attachment would make it more difficult to determine priorities because it is necessary to

63. See Cuming, Walsh and Wood, *supra*, footnote 16, pp. 312-13.
64. Time of attachment is used only when both of the competing security interests are unperfected. See APPSA, s. 35(1)(c); OPPSA, s. 30(1).

delve into facts that that are not matters of public record. Under the PPSA, three conditions must be satisfied in order for attachment to occur: (1) the debtor must sign a written security agreement that describes the collateral (or the secured party must obtain possession of the collateral); (2) value must be given; and (3) the debtor must have rights in the collateral.[65]

A first to attach rule of priority is less desirable as it may be necessary to determine precisely when value was given. Value is not limited to the actual advance of funds, but includes a binding commitment to extend credit.[66] This invites litigation on whether or not there was an obligation to extend credit or merely a non-binding statement of intent. There may also be controversy as to when the formal requirements for a security agreement were satisfied. The security agreement might not record the date of its execution, or there may be allegations that it was backdated. There might also be uncertainty over when some necessary element, such as the inclusion of an appendix listing the collateral, was completed. Priority rules that use time of creation of the security interest are undesirable since they require potential creditors to rely upon the debtor's records,[67] and require courts to make findings of fact long after their occurrence.

The Bank Act regime confers priority on the basis of time of creation of the competing interests. This makes it more difficult for a potential creditor to determine priorities in advance and may require complex fact-finding by courts in order to resolve priority competitions. The potential risk to SPI is magnified since it cannot assume that its earlier registration gives it priority.

(d) Loss of Perfection

Under the PPSA first to register or perfect rule of priority, a subsequent loss of perfection in most PPSA jurisdictions[68] will

65. APPSA, s. 12(1); OPPSA, s. 11(2).
66. APPSA, s. 1(1)(ww), "value"; OPPSA, s. 1(1) "value."
67. See Baird, *supra*, footnote 62, at pp. 64-65.
68. There is a significant difference between the OPPSA and the other PPSA jurisdictions on the effect of a loss of perfection. In the other provinces, a loss of perfection will result in a complete loss of priority by SPI unless SPI re-perfects within 30 days. In Ontario, there is no time limit for re-perfection and SPI only loses its priority in relation to intervening interests. See APPSA, s. 35(8); OPPSA, s. 30(6). And see Cuming, Walsh and Wood, *supra*, footnote 16, pp. 363-368. A loss of perfection is often the result of a lapse or discharge of a registration. In Ontario, a loss of perfection also occurs when a secured party fails to amend its registration upon a change of name of the debtor or a transfer within 30 days of acquiring knowledge of it. See OPPSA, s. 48.

typically result in a loss of priority against a competing security interest. This is illustrated in the following example. SP1 registers first. SP2 registers second. Later, SP1's security interest becomes unperfected. SP2 is now the senior ranking party, and is entitled to priority.

The same does not hold true under the Bank Act as it is not premised on a first to register rule of priority. Substitute a bank for SP2. SP1 will prevail over the bank because its security interest came into existence first. The new Bank Act priority rule does not apply since it only subordinates a PPSA security interest that was unperfected at the time the bank's security was acquired. The priorities are therefore not affected by a subsequent loss of perfection. A bank that discovers that there is no longer an earlier PPSA registration in effect cannot assume that this competing security interest is now out of the picture. Nor can it make future advances on the assumption that it will be entitled to priority.

(e) Relocation of the Collateral or Debtor

The new Bank Act priority provision is not properly integrated with the PPSA conflicts rules, which come into operation when the collateral, or in some cases the debtor, is relocated to another jurisdiction. When goods are relocated into another jurisdiction, the general rule is that secured party must register or perfect in the new jurisdiction in order to maintain its perfected status under the PPSA.[69] In the case of mobile goods held as equipment or lease inventory, it is the relocation of the debtor that triggers this requirement.[70] The general rule is illustrated in the following example. On day one, SP1 registers in Ontario. On day five, goods are relocated from Ontario to Alberta. On day 70, SP2 is given a security interest in the goods in Alberta. SP1 does not register in Alberta within the 60-day period provided for in the PPSA.[71] As a result, SP2 is given priority over SP1.

Now substitute a bank for SP2. The bank is subordinate to SP1. The PPSA priority rules are inapplicable. The Bank Act provides that a security interest is to be considered unperfected only if it has not been registered or otherwise perfected "under the law under which the security interest is created."[72] The security interest was properly registered under Ontario law when the security interest

69. APPSA, s. 5(1); OPPSA, s. 5(1).
70. APPSA, s. 7(2); OPPSA, s. 7(1).
71. APPSA, s. 5(2); OPPSA, s. 5(2).
72. Bank Act, s. 425(1).

was created. The relocation of the goods into Alberta is therefore irrelevant to the question of priorities. But how will the bank know where to search? A search in the provincial registry where the goods are located (Alberta) will not reveal the Ontario registration. And yet the bank will be subject to the PPSA security interest. The new priority rule in the Bank Act is of no use in these situations, since the bank will have unknowingly conducted a search in the wrong registry.

(f) Incompatibility with the PMSI Concept

The Bank Act priority provisions are completely incompatible with the concept of a PMSI under the PPSA. At least five different problems arise. First, as discussed earlier, it would seem that the new priority rule does not apply to title retention devices.[73] The bank will therefore have no means of determining if its Bank Act security will be entitled to first priority as there remains the possibility that the debtor acquired the asset under an earlier title retention device that was not registered.

Second, the Bank Act priority rules seriously undermine the PMSI concept as its priority status is only partially recognized. A Bank Act security is subordinate to a subsequent seller-based PMSI, but not to a lender-based PMSI.[74] Under the PPSA, a lender who takes a PMSI in collateral other than inventory only needs to ensure that it complies with the procedural requirements. If it does so, it will have priority over any earlier PPSA security interest and there is no need for it to conduct a registry search. If there is a possibility that a bank may have given Bank Act security on the asset, the lender cannot assume that it will have this priority. It must therefore conduct a search of the Bank Act registry. If the lender discovers that a bank has taken Bank Act security, the lender must then attempt to negotiate a subordination agreement with the bank or adopt some other costly workaround strategy.[75]

Third, the Bank Act priority rules disrupt the PPSA treatment of production money security interests. The PPSA confers priority to a secured party who extends credit for the purpose of enabling the debtor to acquire inputs for the production of crops or the raising

73. See the discussion under the heading V.2, "Interpretive Problems."
74. See *Royal Bank of Canada v. Moosomin Credit Union*, *supra*, footnote 16.
75. The secured party could arrange for the supplier to sell the equipment under a title-retention device and then obtain an assignment of this agreement. Alternatively the secured party could purchase the equipment from the supplier and then sell it to the debtor under a title retention device.

of animals.[76] The PPSA gives a production money security interest priority over an earlier general financer. But if the general financer is a bank that has been given Bank Act security, the bank will prevail over the input financer.[77]

Fourth, the Bank Act priority rules interfere with the grace periods that are afforded to PMSIs on collateral other than inventory. This is illustrated in the following example. On day one, SP1 takes a lender-based PMSI in farm equipment. On day five, SP2 registers and perfects a security interest in the equipment. On day 10, SP1 registers. Under the PPSA, SP1 prevails since it has a 15-day period within which to register.[78] Now substitute a bank for SP2. The bank obtains priority over SP1 even though SP1's security interest was created before the bank's interest arose. The new Bank Act priority rule provides that an unperfected security interest is subordinate to a security interest that is unperfected at the time the bank acquires its security. Although the PMSI is afforded a grace period for registration under the PPSA, it is not considered to be perfected. Therefore, SP1 is subordinate to the bank despite having registered within the 15-day period. A secured party who takes a lender-based PMSI therefore cannot assume that it will have priority if it registers within the 15-day time period if there is a possibility that a bank may have taken a Bank Act security on the asset during this period.

Fifth, the treatment of PMSIs in inventory is not properly integrated with the Bank Act security system. In order to obtain priority a secured party who has a PMSI in inventory must notify any person who has an earlier registration covering the collateral of its intention to take a PMSI in the inventory. If the competing security interest is a Bank Act security, this process is completely distorted. If the PMSI takes the form of a title retention device, there is no requirement of notice or even registration.[79] The notice requirement does not apply since this notice need only be given to secured parties who have registered in the provincial PPSA registry.

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76. The OPPSA provides for a production money security interest only in respect of crops. See OPPSA, s. 32(1). The other PPSAs provide for a production money security interest for both crops and animals. See APPSA, s. 34(9) and (10).

77. See *Royal Bank of Canada v. United Grain Growers Ltd.*, [2001] 6 W.W.R. 677, leave to appeal to S.C.C. refused 219 Sask. R. 160*n*.

78. APPSA, s. 34(2); OPPSA, s. 33(2).

79. This is the result either because the title retention device does not fall within the definition of a security interest or, alternatively, because the rule only subordinates a security interest that was unperfected at the time that the bank acquired its security.

(g) Circular Priority Systems

The co-existence of two fundamentally different priority systems produces the ideal conditions for the generation of circular priority systems.[80] Three examples should suffice, although several other variations are possible. The first occurs because the Bank Act adopts a *nemo dat* philosophy while the PPSA uses a first to register or perfect concept. On day one, SP1 registers under the PPSA. On day five, SP2 is granted a PPSA security interest and registers under the PPSA. On day 10, a bank takes and registers a Bank Act security. On day 15, SP1 is granted a PPSA security interest. SP2 has priority over the bank because its security interest was created before that of the bank. The bank has priority over SP1, since SP1's security interest was taken after the bank's security was created. But SP1 has priority over SP2 because of its earlier registration. SP2 beats bank; bank beats SP1; SP1 beats SP2.

The second occurs when a lender-based PMSI is involved. On day one, SP1 takes and registers a PPSA security interest that covers after-acquired property. On day five, a bank takes and registers a Bank Act security that covers after-acquired property. On day 10, SP2 takes a lender-based PMSI in goods and complies with the procedural requirements for obtaining priority under the PPSA. SP1 has priority over the bank, since its security interest was first to be created. The bank has priority over SP2, since the bank is first in time and lender-based PMSIs are not afforded priority under the Bank Act. But SP2 has priority over SP1, since lender-based PMSIS are entitled to priority under the PPSA. SP1 beats bank; bank beats SP2; SP2 beats SP1.

The third occurs when a seller-based PMSI is involved. On day one, a bank takes and registers a Bank Act security that covers after-acquired property. On day five, SP1 takes and registers a PPSA security interest that covers after-acquired property. On day 10, SP2 takes a seller-based PMSI in goods but does not comply with the procedural requirements of the PPSA. The bank has priority over SP1, as the bank is first in time. SP1 has priority over SP2, since SP2 did not take the steps needed to obtain its PMSI superpriority under the PPSA. But SP2 has priority over the bank, since the bank obtains only the interest of the buyer and the new Bank Act priority rule does not apply.[81] Bank beats SP1; SP1 beats SP2; SP2 beats bank.

80. For a discussion of circular priority problems, see R.J. Wood, "Circular Priorities in Secured Transactions Law" (2010), 47 Alta. L. Rev. 823.

81. See footnote 79.

The creation of circular priority systems adds a further layer of uncertainty for potential creditors as it becomes very difficult to predict outcomes. Many PPSA jurisdictions have drafted their legislation so as to minimize the possibility of creating circular priority systems in order to decrease the uncertainty and costs associated with them.[82] The lack of compatibility between the PPSA and the Bank Act results in a proliferation of these types of problems.

VI. BACK TO BASICS

The Law Commission of Canada identified three approaches to reform. We could simply scrap the Bank Act security system. This is the simplest and most effective response and one that has been endorsed by the Uniform Law Conference of Canada, the Business Law Section of the Canadian Bar Association, and the Law Commission of Canada. Despite this, the federal government has made it clear that this is not presently considered an option.[83] A second approach is the creation of a federal PPSA. Past efforts have demonstrated that this cure may be worse than the disease.[84] The one situation where a federal PPSA would achieve considerable efficiencies is if it replaced all the provincial and territorial PPSAs as a single national system with a single registry system. Australia has been able to do precisely this within its federal system.[85] This is a singular achievement, but it required a complex series of constitutional arrangements to carry it off. There is virtually no chance that Canada could do the same. The provinces have invested considerable resources in the creation of their registries systems and are unlikely to give them up. The federal PPSA would also need to be bijural so as be compatible with the civil law system of Québec, and this would greatly add to the challenges.

The remaining approach is to amend the Bank Act priority rules in order to create a set of harmonized and co-ordinated priority rules. This was the goal of the CCPPSL/CBA Working Group. Should the recent amendment to the Bank Act be seen as an acceptance and implementation of this option? The answer is that it cannot. Both the Working Group and the Law Commission of Canada contemplated an entirely different approach to amendment. The

82. *Supra*, footnote 80, at pp. 850-852.
83. "2006 Financial Institutions Legislation Review: Proposals for an Effective and Efficient Financial Services Framework," *supra*, footnote 38.
84. See Cuming, *supra*, footnote 23.
85. See Personal Property Securities Act 2009 (Cwth). The constitutional basis and operation of the statute is set out in ss. 242-252.

solution to the problem was seen to be a first to register or perfect rule of priority, subject to an exception for later PMSIs provided that certain procedural steps were taken. It was through this mechanism that the Bank Act priority rules were to be integrated with PPSA concepts.

If this approach to reform had been adopted, most of the problems that have been identified would not arise. Because the priority rule would be based on time of registration or perfection, a secured party who took a security interest would be able to rely upon its advance registration and would not need to worry about a loss of priority to a Bank Act security that arose after registration but before the secured party was granted a PPSA security interest. A loss of perfection would typically lead to a loss of priority. In resolving competitions between registered interests, courts would not need to determine the precise point in time when the respective security interests were created or the state of knowledge of the parties. The PPSA conflict of laws rules would be given full force and effect in determining if the PPSA security interest was registered or perfected. The enhanced priority status of a PMSI would be recognized so long as the secured party took the procedural steps needed to acquire this status. There would be much less scope for the creation of circular priority systems.

Unfortunately, the amendment to the Bank Act does none of this. It retains the basic *nemo dat* philosophy of the Bank Act security device. In doing so it undermines the efficiency of the PPSA whenever there is a possibility that there may be a competing Bank Act security. The secured party cannot rely upon the registry as determining its priority. It cannot rely upon advance registration. A PMSI lender who takes and perfects within the 15-day PPSA time period is not assured of priority, but must take costly alternative steps to ensure that it will obtain priority. Banks who take Bank Act security on inventory will not receive PMSI notices by later PMSI sellers.

On top of these compatibility problems, the new registration rule is flawed. It provides that a failure to register or perfect a security interest at the time the bank obtains its security results in its subordination to the bank. The Bank Act uses the same obsolete pre-PPSA definition of a security interest that is used in other federal statutes. It invites litigation on the question whether this definition covers title retention devices such as conditional sales agreements and security leases. This means that a bank still

cannot rely upon a search of the PPSA registry to determine if there is an existing provincial security interest that is entitled to priority.

VII. CONCLUSION

George Santayana observed that "[t]hose who cannot remember the past are condemned to repeat it."[86] It is regrettable that the work that was undertaken in the past has been so thoroughly forgotten. There was a path out of the morass. It was explored and mapped. But it was all for naught. The lessons have been lost, and we find ourselves still stuck in the mire. Our provincial and federal secured transactions regimes are still not properly co-ordinated. The outcomes that are produced are not commercially sensible. The new amendment does not lead us out of this mess because it continues to adhere to the *nemo dat* philosophy. By doing so, it undermines several foundational features of modern secured transactions law and makes it necessary for secured parties to adopt more costly practices whenever there is a prospect of a contest with a bank that holds Bank Act security.

86. George Santayana, *Reason in Common Sense*, vol. 1 of *The Life of Reason; or, The Phases of Human Progress* (New York, C. Scribner's Sons, 1905), p. 284.