

Holding the High Ground: The Position of Secured Creditors in Consumer Bankruptcies and Proposals

Tamara M. Buckwold

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Holding the High Ground: The Position of Secured Creditors in Consumer Bankruptcies and Proposals

Abstract

This article examines the position of secured creditors in the event of a consumer debtor's bankruptcy or the filing of a consumer proposal, as determined by the federal and provincial laws of Canada. Secured creditors in Canada are in a remarkably powerful position relative to other claimants in bankruptcy and to their counterparts in the United States. Their rights of realization against the collateral are essentially unaffected by the initiation of either a consumer bankruptcy or proposal. Moreover, recent judicial developments appear to further enhance secured creditors' rights of enforcement, both against the in personam payment obligation and against the bankrupt's property after his or her discharge.

HOLDING THE HIGH GROUND: THE POSITION OF SECURED CREDITORS IN CONSUMER BANKRUPTCIES AND PROPOSALS[©]

BY TAMARA M. BUCKWOLD*

This article examines the position of secured creditors in the event of a consumer debtor's bankruptcy or the filing of a consumer proposal, as determined by the federal and provincial laws of Canada. Secured creditors in Canada are in a remarkably powerful position relative to other claimants in bankruptcy and to their counterparts in the United States. Their rights of realization against the collateral are essentially unaffected by the initiation of either a consumer bankruptcy or proposal. Moreover, recent judicial developments appear to further enhance secured creditors' rights of enforcement, both against the *in personam* payment obligation and against the bankrupt's property after his or her discharge.

Cet article examine la position des créanciers garantis dans le cas d'une faillite de consommateurs débiteurs ou la réclamation par une proposition de consommateurs, tels que déterminés par les lois fédérales et provinciales au Canada. Les créanciers garantis sont dans une position de force remarquable par rapport aux autres plaignants en faillite et par rapport à leurs homologues aux États-Unis. Leurs droits de réalisation contre le collatéral ne sont essentiellement pas affectés ni par l'initiation d'une faillite de consommateurs ni par une proposition. En plus, des développements juridiques récents semblent favoriser davantage le renforcement des droits des créanciers garantis, à la fois contre l'obligation de paiement *in personam* et contre la propriété de la personne en faillite après son acquittement.

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I. INTRODUCTION

Secured creditors rarely bear direct responsibility for the initiation of consumer bankruptcy proceedings, since the rights of realization associated with their security provide an expeditious route to debt recovery. Secured debt therefore affects the rate of consumer bankruptcy principally as a component of the total financial burden borne by individuals and unincorporated businesses. Heavy secured debt obligations may also contribute indirectly to default in the payment of unsecured debt, thereby precipitating bankruptcy through either an assignment by the debtor or the petition of unsecured creditors. Small entrepreneurs and individual consumers whose major assets are the collateral for secured debt may neglect taxation authorities and other unsecured creditors—in order to avoid defaulting on payment of the loans underlying the security—in an attempt to avert the seizure of precious items of collateral. However, no empirical studies are available to sustain anything but speculative conclusions about the relationship of secured debt to consumer bankruptcy in Canada.

In the absence of a basis for meaningful commentary on secured debt as a cause of bankruptcy, an examination of its role must focus on the converse question, namely, the effect of bankruptcy on secured creditors' rights. This article therefore explores the legal position of secured creditors in the context of consumer bankruptcy, and in relation to consumer proposals under the *Bankruptcy and Insolvency Act (BIA)*.¹ The discussion reveals that secured creditors in Canada “hold the high

¹ R.S.C. 1985, c. B-3 [hereinafter *BIA*].

ground” as compared with other creditors in terms of their ability to recover debt owed by bankrupt consumers. Neither bankruptcy nor the approval of a consumer proposal restricts their ability to seize and sell the property subject to their security in satisfaction of the debt secured. Regardless of the extent to which secured credit contributes to the initiation of bankruptcy proceedings or the making of a proposal, it will be seen that secured credit largely operates outside the principles and policies that otherwise govern creditors’ rights in bankruptcy.

II. THE POSITION OF SECURED CREDITORS

The rights of secured creditors outside bankruptcy are determined by the laws of the respective provinces under their constitutional jurisdiction over property and civil rights.² Secured creditors’ rights are twofold: first, they are entitled to enforce the debtor’s contractual promise to pay the debt or perform the payment obligation arising from the security agreement; second, they are entitled to realize on their security. In general, this means that a secured creditor may seize and sell the property subject to the security interest, and apply the proceeds to satisfy any sum outstanding.³

The secured creditor’s rights of realization are of paramount importance, since the availability of identified property to satisfy all, or a significant portion, of the credit advanced offers concrete assurance of repayment. In contrast, both informal and legal action to enforce the personal promise to pay are expensive, inefficient, and frequently unsuccessful. Although federal jurisdiction over bankruptcy clearly encompasses the statutory modification of the legal position of secured creditors, Parliament has not intervened in any substantial way in the exercise of rights of realization.⁴

² See *Constitution Act, 1867* (U.K.), 30 & 31 Vict., c. 3, s. 92(13), reprinted in R.S.C. 1985, App. II, No. 5.

³ For a discussion of rights of realization against personal property collateral in Ontario and in most of the other provinces and territories, see J.S. Ziegel & D.L. Denomme, *The Ontario Personal Property Security Act: Commentary and Analysis* (Aurora, Ont.: Canada Law Book, 1994); and R.C.C. Cuming & R.J. Wood, *British Columbia Personal Property Security Act Handbook*, 3d ed. (Toronto: Carswell, 1996). For a comprehensive description of rights of realization against land, see J.E. Roach, *The Canadian Law of Mortgages of Land* (Markham, Ont.: Butterworths, 1993).

⁴ The 1992 amendments to the *BIA* imposed notice and procedural requirements on secured creditors intending to enforce their security on the business assets of an insolvent person. However, those requirements simply delay the exercise of rights of realization for a ten-day period, and are, in any event, not relevant in most consumer bankruptcies: see *BIA*, *supra* note 1, s. 244, as am. by *An Act to amend the Bankruptcy Act and to amend the Income Tax Act in consequence thereof*, S.C. 1992, c.

By the time a debtor is faced with bankruptcy, he or she will typically have defaulted in making the payments due under the security agreements⁵ giving rise to the secured debt obligations. Even if payments have been maintained, virtually all security agreements provide that the making of an assignment or the filing of a petition in bankruptcy constitutes default by the debtor. In either case, the event of default triggers the right of secured creditors to realize against the property subject to their security interests (the collateral) in accordance with the requirements of provincial law governing the exercise of those rights. The following discussion therefore proceeds on the assumption that default is established.

A. *The Assertion of Secured Claims Under the BIA*

With few exceptions, secured creditors may exercise the rights of seizure and sale, granted or recognized by provincial law, after the initiation of their debtor's bankruptcy to the same extent as they can when a default occurs outside bankruptcy.⁶ For the most part, these rights will be determined by the provincial personal property security acts (PPSAs),⁷ real property law, exemptions legislation, and an assortment of ancillary statutes.⁸ Provincial law applies without differentiation to pre-bankruptcy and post-bankruptcy seizures in the

²⁷, s. 89 [hereinafter *1992 Amendments*].

⁵ "Security agreement" is used generically to refer to any contract that gives a creditor an interest in property of the debtor as security for recovery of a debt. This includes real property mortgages, personal property security agreements, chattel mortgages, conditional sales agreements, and other consensual security devices.

⁶ Statements affirming this proposition may be found in many cases. For a recent reiteration, see *Mackesey v. Royal Bank of Canada* (1991), 86 D.L.R. (4th) 637 (Sask. C.A.).

⁷ Statutes of this kind have been enacted by both territories and all of the provinces except Newfoundland and Quebec. The abbreviation "PPSA" will be used hereinafter generically in reference to these statutes cumulatively, or specifically in reference to one or more of them as the context indicates. Identified sections of the British Columbia *Personal Property Security Act*, R.S.B.C. 1996, c. 359 [hereinafter *PPSA (B.C.)*] will be used to illustrate the content and effect of particular PPSA provisions. For other jurisdictions, see New Brunswick, *Personal Property Security Act*, S.N.B. 1993, c. P-7.1 [hereinafter *PPSA (N.B.)*]; Nova Scotia, *Personal Property Security Act*, S.N.S. 1995-96, c. 13 [hereinafter *PPSA (N.S.)*]; Prince Edward Island, *Personal Property Security Act*, S.P.E.I. 1997, c. 33, s. 58 [hereinafter *PPSA (P.E.I.)*]; Ontario, *Personal Property Security Act*, R.S.O. 1990, c. A-33; Manitoba, *Personal Property Security Act*, R.S.M. 1987, c. P35; Alberta, *Personal Property Security Act*, S.A. 1988, c. P-4.05; Saskatchewan, *The Personal Property Security Act, 1993*, S.S. 1993, c. P-6.2; Northwest Territories, *Personal Property Security Act*, S.N.W.T. 1994, c. 8; Yukon, *Personal Property Security Act*, R.S.Y. 1986, c. 130.

⁸ Section 72(1) of the *BIA*, *supra* note 1, preserves the operation of provincial laws and statutes "relating to property and civil rights that are not in conflict with this Act"

absence of conflicting rules in federal bankruptcy legislation. The *BIA* contains only a few provisions affecting secured creditors' rights. Even those procedural provisions relating to the filing of proof of claim and valuations of security are not mandatory, unless the trustee elects to demand a proof of security.

1. The exemption of secured creditors from the automatic stay

Section 69.3(1) of the *BIA* imposes a general stay on the exercise by creditors of any remedy against a bankrupt debtor or that debtor's property. However, in a reversal of the old axiom, what is taken away with one hand is, in this case, given to secured creditors with the other. Insofar as their rights of realization against the bankrupt's property are concerned, section 69.3(2) exempts secured creditors from the general stay, providing that "the bankruptcy of a debtor does not prevent a secured creditor from realizing or otherwise dealing with his security in the same manner as he would have been entitled to realize or deal with it if this section had not been passed ...".⁹

A secured creditor's right to seize collateral is limited only by those provisions of the *BIA* designed to allow the trustee to appraise the value of the property claimed as security, and to ensure that any residual value after deduction of the secured claim is made available for the benefit of the estate.¹⁰ The philosophy underlying the *Act* appears to be correctly stated by Vertes J. in *Northwest Territories (Commissioner) v. Simpson Air*: "The policy of the Act is not to interfere with the rights of secured creditors except insofar as may be necessary to protect the estate as to any surplus. The Act is clear that the Trustee takes subject to the rights of the secured creditors."¹¹

While the *Act* empowers the trustee to redeem property held as security, the trustee may do so only upon payment in full of the debt secured or the value of the security.¹² If the debt is fully secured, this means, of course, that the secured creditor will recover the full amount of his or her claim, whether through realization or through redemption of the collateral by the trustee.

⁹ *BIA*, *supra* note 1, s. 69.3(2). The court's limited and infrequently exercised jurisdiction under section 69.3(2) to temporarily postpone a secured creditor's right to realize on his or her security is discussed in Part II(A)(4), below.

¹⁰ See *ibid.* ss. 79, 127-134, 135.

¹¹ [1994] N.W.T.R. 184 at 189 (N.W.T. S.C.) [hereinafter *Simpson Air*].

¹² See *BIA*, *supra* note 1, s. 128(3).

2. Proof of secured claims and procedure on seizure

Most authorities agree that a secured creditor who elects to realize his or her security after the institution of bankruptcy is free of any compulsory procedural obligations under the *BIA*. Although ostensibly mandatory, the provisions that "(e)very creditor shall prove his claim,"¹³ and that the proof of claim "shall state" whether the creditor is or is not secured¹⁴ need not be observed by a secured creditor unless he or she wishes to claim as an unsecured debt any deficiency remaining after deducting the value of the collateral from the total debt owed.¹⁵ The secured creditor therefore need not notify the trustee or any other bankruptcy official of his or her intention to seize, or even of the existence of a claim prior to seizure.

Some courts have disputed this view. In *R. v. Mathers*,¹⁶ Wedge J. held that the exercise by a secured creditor of the rights of realization countenanced by section 69.3 (then section 49(2)) was subject to the trustee's right under section 81 to receive a proof of claim before giving up possession of collateral. She accordingly found a secured creditor's agent, who had seized collateral without first obtaining the permission of the trustee, to have violated section 203 (then section 174). Section 203, in substance, stipulates that any person who removes property mentioned in section 81 from the possession of the bankrupt without permission of the trustee is guilty of an offence, unless thirty days have passed since the filing of the proof of claim required by that section. The fact that the defendants had ultimately established their entitlement to seize the vehicles in question was irrelevant.

This decision rests on the view that secured creditors are subject to the terms of section 81(1), which provides that any "person [who] claims any property, or interest therein, in the possession of a bankrupt at the time of the bankruptcy, ... shall file with the trustee a proof of claim" Read in isolation, this provision appears to apply to secured creditors, since the assertion of a security interest represents a claim to an interest in property. However, the view that security interests do not

¹³ *Ibid.* s. 124(1).

¹⁴ *Ibid.* s. 124(5).

¹⁵ See *Re McMurdo*, [1902] 2 Ch. 684 (C.A.); and *Shink v. Gingras*, [1962] C.S. 297 (Qc. Sup. Ct.).

¹⁶ (1979), 30 C.B.R. (N.S.) 133 (Sask. Prov. Ct.). See also *R. v. Ford Motor Credit Co.* (1977), 25 C.B.R. (N.S.) 283 (Man. Prov. Ct.); and *R. v. Bank of Montreal* (1984), 53 C.B.R. (N.S.) 287 (Man. Prov. Ct.), *aff'd* (1985), 58 C.B.R. (N.S.) 45 (Man. Q.B.), *rev'd* on other grounds (1986), 60 C.B.R. (N.S.) 169 (Man. C.A.).

fall within its purview accords with the overall structure of the *BIA*, and with its virtually uniform policy of non-intervention with the exercise of rights of realization. In *R. v. Ford Credit Canada Ltd.*, Austin J. argued convincingly for this interpretation.¹⁷

The provisions of the *BIA* establishing the procedures specific to the claims of secured creditors do not obligate a secured creditor to file a proof of claim. Further, the wording and manifest objective of section 69.3(2), which exempts secured creditors from the automatic stay, are inconsistent with the view that secured creditors' rights of realization are delayed under the more general provisions of section 81. The distinctive procedure established by section 81 must therefore be designed to address a situation in which a person claims ownership of property in the bankrupt's possession other than through the assertion of a security interest.

The inclination of some courts to control the exercise by secured creditors of their rights of seizure through the application of sections 81 and 203 is understandable. A secured creditor's election to seize the security immediately after the initiation of the debtor's bankruptcy may impair the trustee's ability to catalogue the bankrupt's assets, and to ascertain the value of collateral with a view to determining whether it has residual worth beyond the amount of the secured debt. However, the thirty-day stay against seizure that might be imposed on secured creditors by these sections could jeopardize the realization value of the collateral by delaying a sale, harming the secured creditor and others with a claim against the debtor's equity. Whether or not the *BIA* should impose some restraint on the exercise of secured creditors' rights of seizure, Austin J. rightly concludes that, in its present formulation, it does not do so.¹⁸

3. Mandatory sale or redemption of collateral by the trustee

Even without having received a proof of claim, the trustee should be alerted to the existence of security interests to which the bankrupt's property is subject, either through information provided in the debtor's Statement of Affairs or by a search of the appropriate registries. Section 79 is designed to facilitate the trustee's determination of whether the value of property held as security warrants its redemption by enabling

¹⁷ (1990), 78 C.B.R. (N.S.) 266 (Ont. S.C.) [hereinafter *Ford Credit*], leave to appeal to Court of Appeal refused without comment on this point (1991), 2 C.B.R. (3d) 1 (Ont. C.A.).

¹⁸ See *Ford Credit*, *supra* note 17 at 273-78.

the trustee to temporarily delay realization. It prevents a secured creditor from realizing his or her security until the trustee has been given "a reasonable opportunity of inspecting the property and of exercising the trustee's right of redemption," where the trustee has given a secured creditor notice in writing of his or her intention to inspect.¹⁹

The *BIA* also empowers the trustee to require a secured creditor to provide an assessment of the value of the property in which a security interest is claimed as a basis for the exercise of the right of redemption.²⁰ If the trustee is dissatisfied with the value assessed, he or she may require that the property be sold.²¹ The trustee will, of course, redeem the collateral or require its sale if there is some basis upon which to believe that it is worth more than the debt owed the secured creditor, potentially enhancing the estate of the bankrupt available for distribution to unsecured claimants. However, neither the redemption nor the forced sale of the collateral affects the substantive rights of the secured creditor, who, in any event, will recover the value of the security.²²

4. Postponement of seizure by court order

Only one other procedural device is available to delay the realization of a security interest. Section 69.3(2), which acknowledges the general right of secured creditors to realize their security free of the stay imposed by subsection (1), provides for a court order postponing the exercise of rights of realization for up to six months. However, it appears that such an order will be granted only where there is evidence that the secured creditor is likely to realize in a fashion that will yield an unreasonably low return, thereby unduly increasing the amount of that creditor's claim that might be proven as an unsecured debt in the event of a deficiency, or perhaps prejudicing the interests of those entitled to share in a potential surplus.

¹⁹ *BIA*, *supra* note 1, s. 79.

²⁰ Section 128, *ibid.*, provides that the trustee may require the secured creditor to file a proof of security, including an assessment of its value. The trustee may redeem the security on payment to the secured creditor of the debt or the value of the security as assessed by the creditor.

²¹ *Ibid.* s. 129.

²² Under section 135, *ibid.*, the trustee also has the power to disallow a claim or a security, subject to a right of appeal to the court. This power simply protects the estate from the loss of property through unfounded claims. It does not affect the holders of legitimate security interests.

In *Simpson Air*, the Court refused an order postponing the exercise by a private receiver of the secured creditor's right of sale where the receiver had acted in an "economically efficient and commercially reasonable manner."²³ There was no clear evidence that a more favourable sale could be achieved, in spite of the trustee's contention that sale of the business as a going concern might reap a higher return. Seizure or sale by the secured creditor will apparently be postponed only if there are "cogent reasons"²⁴ to conclude that he or she might not act in such a way as to procure the highest possible return, thereby prejudicing those entitled to participate in a surplus.²⁵ This standard mirrors the obligation imposed by provincial law on secured creditors acting in a non-bankruptcy context to act in good faith and in a commercially reasonable manner in exercising rights of realization.²⁶

B. *The Personal Obligation to Pay: Secured Creditors' Recovery of Unsecured Debt*

The privileged position of a secured creditor whose debtor has become a bankrupt is coextensive with the value of the creditor's security. The right to enforce the debt underlying a security interest is distinct from, though obviously related to, the creditor's rights in the collateral. Although a secured creditor's rights of realization are substantially unimpaired by the *BIA*, the secured creditor stands in the same position as an unsecured creditor with respect to enforcement of the bankrupt debtor's personal obligation to pay.

A secured creditor may prove a claim for the entire amount of the debt owed if he or she elects to surrender the security to the trustee for the general benefit of creditors.²⁷ Similarly, a secured creditor may prove a claim for any deficiency after deducting the net realization value

²³ *Simpson Air*, *supra* note 11 at 192.

²⁴ *Ibid.* at 189, citing *Re Dunham* (1981), 40 C.B.R. (N.S.) 25 (Ont. S.C.).

²⁵ In *Re Les Pharmacies Modernes Inc.* (1974), 19 C.B.R. 161 (Qc. Sup. Ct.), the court appears to have adopted a less stringent standard in granting the trustee's application for a two-month postponement of the secured creditor's realization of the bankrupt's assets.

²⁶ See, for example, *PPSA (B.C.)*, *supra* note 7, s. 68(2).

²⁷ See *BIA*, *supra* note 1, s. 127(2). Where a secured creditor has clearly surrendered its security to the trustee, electing thereby to pursue the debt as an unsecured creditor, the secured creditor may not thereafter assert any claim to the security. For the considerable body of case law on the question of when a secured creditor will be regarded as having surrendered its security, see L.W. Houlden & G.B. Morawetz, *Bankruptcy and Insolvency Law of Canada*, vol. 2, 3d ed., looseleaf (Toronto: Carswell, 1998) at G§46A.

or the assessed value of the security from the total amount of the debt.²⁸ With regard to any portion of the debt that is unsecured, or that the creditor elects to pursue as unsecured, the otherwise secured creditor is thus entitled to vote at creditors' meetings and to share in any dividend on the same basis as other unsecured creditors. The right to sue on the personal obligation to pay is, of course, stayed by section 69.3(1) of the *BIA*, subject to the discretionary power granted the court to lift the stay under section 69.4.²⁹

In practice, an undersecured creditor may not bother to submit a proof of claim for a deficiency if the bankrupt's non-exempt property is apparently of insufficient value to generate any meaningful payment of unsecured debt. Conversely, creditors who are only nominally secured often prove as if they were unsecured if there is not sufficient value in the collateral to satisfy their claim, and there is some prospect that a dividend may be paid.

C. *Post-Discharge Enforcement of the Security Interest and the Underlying Debt*

The position of a secured creditor regarding enforcement of the security interest and the debtor's personal obligation is determined by the interplay of two fundamental principles embodied in the *BIA*. The first is that an order of discharge releases the bankrupt from all claims provable in bankruptcy.³⁰ Since a secured debt, like any other, is a claim provable in bankruptcy, one might think that the release by the bankrupt's discharge of the debt secured would entail release of the security interest it supports. However, that result is forestalled by the intervention of the second fundamental principle, that a trustee in bankruptcy is entitled to distribute only the "property of the bankrupt" as it is defined by section 67 of the *BIA*. To the extent that such property is subject to an enforceable third-party interest, that interest survives the bankruptcy—both before and after the debtor's discharge. In other words, proprietary interests vested before the bankrupt's discharge are not property of the bankrupt subject to the bankruptcy proceedings, except insofar as provisions of the *BIA* enable the trustee to acquire such

²⁸ See *BIA*, *supra* note 1, ss. 127(1), 128(2).

²⁹ See *Imperial Lumber Co., Ltd. v. Johnson* (1923), 3 C.B.R. 707 (Alta. S.C. A.D.); *Re Rockland Chocolate and Cocoa Co., Ltd.* (1921), 1 C.B.R. 452 (Ont. S.C.); and *Dutch Canada Kent Credit Union Ltd. v. Sprik* (1981), 36 C.B.R. (N.S.) 179 (Ont. S.C.).

³⁰ See *BIA*, *supra* note 1, s. 178(2).

interests.³¹ If the trustee has not elected to redeem the security, a secured creditor may accordingly enforce the security interest while the debtor is in bankruptcy, or defer realization until after discharge.³²

1. Post-discharge enforcement of the obligation to pay

The general discharge provision of the *BIA* is the statutory incarnation of the "fresh start" policy constituting one of the primary premises of Canadian bankruptcy law. The scope of that provision is extremely broad. Section 178(2) provides that upon receiving his or her discharge from bankruptcy, a debtor is "released" from all claims provable in bankruptcy. Claims provable in bankruptcy, as defined by section 121, include all debts, present or future, to which the bankrupt is subject on the date of bankruptcy, or to which he or she may become subject before discharge by reason of an obligation incurred before bankruptcy. Since secured debt clearly falls within the broad wording of section 121, the debtor is "released" by his or her discharge from the personal obligation of payment the debt represents. Accordingly, a secured creditor cannot sue to enforce the debt *in personam*, either in full or to the extent of any deficiency claim that would otherwise arise in cases in which the exercise of rights of realization against the collateral does not, or will not, yield proceeds sufficient to retire the loan or credit extended.

The *BIA* does not contemplate the preservation or revival of pre-discharge debt obligations by agreement between the parties or otherwise. However, that result may be achieved in the context of a secured credit relationship under the general contract law principles of compromise or forbearance. If the debtor's default entitles the secured creditor to seize collateral that the debtor does not want to lose, the debtor may well be prepared to agree to repay debt that would otherwise be discharged, in return for the creditor's agreement to refrain from exercising his or her rights of realization. The creditor's forbearance to exercise an existing legal right is consideration for the debtor's

³¹ In the case of security interests, this may be accomplished through redemption of the security: see *ibid.* s. 128(3).

³² Section 130, *ibid.*, enables a secured creditor to require the trustee to elect between either exercising the power of redeeming the security or requiring the security to be realized.

agreement to pay a sum of money.³³ The amount of debt “affirmed”—or, to use the terminology of United States bankruptcy law, “reaffirmed”—and the terms of payment may differ from what was established by the contract under which the pre-discharge debt originated.³⁴ Whether or not the debtor has an incentive to resume a payment obligation from which he or she would otherwise be absolved by the discharge will depend on the importance the debtor attaches to the item of collateral in question.

The potency of section 178(2) is confirmed by the courts’ characterization of its effect. In *Holy Rosary Parish (Thorold) Credit Union Ltd. v. Bye*,³⁵ Judson J. of the Supreme Court of Canada addressed a creditor’s post-discharge attempt to enforce a debt secured by an assignment of wages granted by the debtor prior to his bankruptcy. Dismissing the creditor’s claim to wages accruing due after the debtor’s discharge, Judson J. said, “[t]here is no doubt that the borrowing by [the debtor] from the credit union did create a debt provable in bankruptcy. The debt has now gone by operation of law.”³⁶ In *Re Pelyea and Canada Packers Employees Credit Union Ltd.*,³⁷ MacKay J.A. of the Ontario Court of Appeal said that the debt owed to a secured creditor at the time of a bankruptcy is “extinguished,” though the security in existence at the date of the bankruptcy is not.³⁸

³³ It is trite law that a simple promise to pay an existing debt is not enforceable, since nothing new is offered by way of consideration on the part of the creditor: see, for example, *Foakes v. Beer* (1884), 9 A.C. 605 (H.L.). In the context of bankruptcy, a creditor’s promise to forbear from suing on a pre-discharge debt cannot be consideration, since the bankrupt is released by the discharge from the obligation to pay that debt: see *Heather & Son v. Webb* (1876), 2 C.P.D. 1 (H.C.J.). However, because a secured creditor’s rights of realization survive the discharge, the forbearance to exercise those rights can be consideration.

³⁴ A contractually binding agreement to pay debt arising from an existing contract is sometimes referred to in Canadian courts as “novation.” The word is presumably referable to the renewal or “novation” of the existing obligation. This terminology is used in *Seaboard Acceptance Corp. v. Moen* (1986), 62 C.B.R. (N.S.) 143 (B.C. C.A.).

³⁵ [1967] S.C.R. 271 [hereinafter *Bye*].

³⁶ *Ibid.* at 274. For a recent review of authorities supporting the view that debt is extinguished by section 178(2), see the judgment of Scarth J. in *Tildesley v. Weaver* (4 August 1988), Victoria, 98 0483 (S.C.), [1998] B.C.J. No. 1838, online: QL (BCJ).

³⁷ [1970] 2 O.R. 384 (C.A.) [hereinafter *Re Pelyea*].

³⁸ *Ibid.* at 388.

Others take the view that pre-discharge debt is rendered unenforceable, though it notionally continues in existence.³⁹ On either view, a secured creditor clearly has no right to enforce the personal promise of payment supporting a debt incurred prior to the debtor's discharge in the absence of a contractually binding reaffirmation. However, some courts have apparently failed to observe this principle, opening the way for secured creditors to enforce the unsecured portion of the debt owed after the debtor's discharge.

This problem stems from the short judgment rendered by the British Columbia Court of Appeal in *Seaboard Acceptance Corporation v. Moen*.⁴⁰ The bankrupt had maintained the payments due under an automobile lease throughout her bankruptcy and for a period of time after her discharge, but ultimately stopped making payments and returned the vehicle to the lessor. The Court of Appeal endorsed the trial decision, which granted Seaboard Acceptance Corporation judgment for the balance due under the contract.

The Court of Appeal premised its decision on the assumption that the debt claimed by Seaboard Acceptance Corporation under the lease was a claim provable in bankruptcy. In response to the contention that the lessee's discharge had released that debt, the Court held that

the contract continued throughout the bankruptcy and continued after the discharge from bankruptcy; it was never terminated in accordance with its provisions for termination, and the fact that there might have been a claim provable in bankruptcy, or that a claim provable in bankruptcy might have been made, does not affect the fact that the contract itself continued and continued to regulate the relationship of the parties after the discharge from bankruptcy.⁴¹

This conclusion apparently rested on the maintenance of payments throughout the lessee's bankruptcy and beyond, constituting what the Court called an endorsement of the contract after her discharge. Lambert J.A. specifically indicated that there had not been a novation of the contract, merely a "continuation" of it.⁴²

³⁹ See *Re Kryspin* (1983), 44 C.B.R. (N.S.) 232 (Ont. S.C.); *Re Handelman* (1997), 48 C.B.R. (3d) 29 (Ont. Ct. (Gen. Div.)); and *Gagnon v. Fiducie Desjardins* (1992), 17 C.B.R. (3d) 92 (Qc. S.C.), aff'd [1993] A.Q. No. 1645 (C.A.), online: QL (QJ). This view is consistent not only with the wording used in the *BJA* ("released" rather than "extinguished" or "nullified"), but also with the continuation of the secured creditor's proprietary rights after discharge. A proprietary right or interest comprising nothing more than a right to apply the value of the collateral to the satisfaction of a debt presumes the existence of a debt to be satisfied. For authorities supporting this characterization of the nature of a security interest, see note 54, *infra*.

⁴⁰ *Supra* note 34 [hereinafter *Seaboard*].

⁴¹ *Ibid.* at 147.

⁴² *Ibid.*

The decision in *Seaboard* is clearly insupportable in the absence of a contractual reaffirmation of the debt or novation of the contract of lease, which would depend on the existence of new consideration.⁴³ The notion of a “continuation” of the contract is simply without intelligible legal content.⁴⁴

The potential for application of the flawed reasoning in *Seaboard* has apparently been realized in at least two recent cases. In *Manulife Bank of Canada v. Planting*,⁴⁵ *Seaboard* was cited as authority for the view that a deficiency claim arising from a debt secured by a real property mortgage could be enforced against the mortgagors after their discharge from bankruptcy, on the grounds that the mortgagee had not proven a claim in bankruptcy, and the debtors had remained in possession of the security and paid interest on the debt throughout the bankruptcy period. As in *Seaboard*, the court was explicit in not basing its decision on a novation of the original mortgages.

The judgment in *Manulife* adds nothing to the reasoning advanced in *Seaboard*. Although the mortgagees’ appeal to the Ontario Court of Appeal created an opportunity for the elucidation of the *Manulife* decision, that opportunity was unfortunately lost, since the Court dismissed the appeal without reasons, except as to the liability of the male defendant under a guarantee executed before the bankruptcy.⁴⁶

Any hope that this short and clearly insupportable line of authority might be overlooked or avoided by other courts was recently undermined by Hart J. of the Alberta Court of Queen’s Bench in *C.I.B.C. Mortgage Corp. v. Stenerson*,⁴⁷ confirming a deficiency judgment granted in a foreclosure action commenced after the mortgagor’s discharge from bankruptcy. Hart J. quoted from *Seaboard* and from

⁴³ Any estoppel that might be alleged on the grounds of the debtor’s continuation of payments cannot overcome the operation of the statutory provision. The principle that an estoppel cannot supersede an obligation to perform a statutory duty is well established: see *Kenora (Town) Hydro Electric Commission v. Vacationland Dairy Co-operative Ltd.*, [1994] 1 S.C.R. 80. Analogous reasoning would dictate that an estoppel cannot operate to enable a creditor to enforce an obligation declared unenforceable (or extinguished) by statute.

⁴⁴ In *Scotia Mortgage Corp. v. Winchester* (1997), 46 C.B.R. (3d) 314 (Alta. Master), faced with a submission based on *Seaboard*, Master Funduk distinguished the case on the basis that the court appeared to have said that a new contract was entered into after the bankrupt went into bankruptcy. Although this is clearly not what the court said in *Seaboard*, Master Funduk may be forgiven for attempting to explain the decision away.

⁴⁵ (1996), 43 C.B.R. (3d) 305 (Ont. Ct. (Gen. Div.)) [hereinafter *Manulife*], rev’d in part (9 January 1998), C26491, [1998] OJ No. 74 (C.A.) online: QL (OJ) [hereinafter *Manulife C.A.*].

⁴⁶ See *Manulife C.A.*, *supra* note 45.

⁴⁷ (1998), 220 A.R. 248 (Q.B.) [hereinafter *Stenerson*].

Howden J. in *Manulife*. He then concluded that because the mortgagor had “affirmed” the contractual relationship by making mortgage payments throughout the bankruptcy, the mortgagee did not lose its right to a deficiency judgment by reason of the mortgagor’s bankruptcy.⁴⁸

The jurisprudence represented by *Seaboard*, *Manulife*, and *Stenerson* is clearly inconsistent with the fresh start policy, which grounds the release of provable claims occasioned by the discharge of a consumer bankrupt, as well as with the clear wording of section 178(2). It constitutes a significant enhancement of the already strong position enjoyed by secured creditors—an enhancement that is unsupported by either an articulated policy or a credible doctrinal analysis.

From a policy perspective, the contractual reaffirmation of pre-bankruptcy debt might also be criticized for besmirching the clean financial slate mandated by the fresh start policy. However, the validity of such a reaffirmation is justified by the debtor’s deliberate decision to pay the stipulated price in order to preserve collateral that he or she regards as vital, provided that the choice is informed and voluntary. The reasoning in *Seaboard* effectively imposes a reaffirmation upon the debtor without clear evidence that such a choice has been made or even contemplated. Surely, the maintenance of payments and the retention of the collateral cannot in themselves be regarded as conduct demonstrating a decision to forego the benefits of discharge with respect to the credit transaction in question. Such a course of conduct is more likely indicative of the debtor’s pragmatic attempt to retain possession of the collateral, without any appreciation of the legal alternatives.⁴⁹

2. Security realization after the debtor’s discharge from bankruptcy

There is no doubt that any security interest attached to property of the bankrupt extant at the date of discharge survives the discharge, and is enforceable by the secured creditor at a subsequent date, notwithstanding the release of the underlying debt. As stated by Robins J. in *Manufacturers Life Insurance Company v. Burton*,

⁴⁸ *Ibid.* at 251.

⁴⁹ In the United States, inadvertent reaffirmation of the kind countenanced by *Seaboard* would be unthinkable. The potential for unconscionable manipulation of debtors presented by enforcement of ostensibly voluntary reaffirmations of pre-discharge debt was clearly recognized by the drafters of the United States *Bankruptcy Code*, 11 U.S.C. § 524(c) (1998). It requires, *inter alia*, some evidence that reaffirmations represent a voluntary and informed choice, and that they are not unduly prejudicial to the debtor’s interests.

[w]hile s.148(2) [now 178(2)] extinguishes the debts owed by a bankrupt at the time of bankruptcy, it does not release the security of a creditor which validly existed at the time of bankruptcy; the security continues in force although, as *Bye* and *Pelyea* establish, it cannot attach to assets which come into existence subsequent to the date of discharge.⁵⁰

In *Re Pelyea*,⁵¹ the Ontario Court of Appeal granted a creditor's post-bankruptcy claim to enforce an assignment of the bankrupt debtor's interest in an employees' profit-sharing plan, to the extent of money accrued to him at (but not after) the date of his discharge. Similarly, the Supreme Court of Canada in *Bye*⁵² held that an assignment of the debtor's interest in an employee profit sharing fund could be enforced by a creditor who had taken the assignment as security for a pre-bankruptcy debt, to the extent of money accrued in the fund up to, but not after, the date of the debtor's discharge from bankruptcy.

This view is not only authoritatively binding on lower courts, but doctrinally correct. A security interest represents nothing more than a right to resort to property of the debtor to satisfy an outstanding payment obligation or debt. Since the interest adheres or "attaches"⁵³ to identified property and gives the creditor *in rem* rights of enforcement against that property, it is a proprietary interest. However, the proprietary interest is purely accessory to the debt supporting it. Once the debt is satisfied and thus ceases to exist, the security interest vanishes, since the creditor no longer has a right to resort to the collateral for the debt's payment. Similarly, if section 178(2) of the *BIA* either extinguishes pre-discharge debt or deprives the creditor of the right to enforce it following the debtor's discharge, that debt cannot support a security interest in property subsequently acquired by the debtor. The creditor cannot have a right to resort to that property for satisfaction of the pre-discharge debt, because the creditor has no right to enforce the debt itself.

Both a security interest in personal property under the Canadian PPSAS and a mortgage against land in a Torrens land registration jurisdiction confer upon the creditor proprietary rights of this kind. Neither system contemplates a transfer of title to the collateral to the secured creditor as the basis of the creditor's rights of realization. Rather, the security interest represents a prescribed bundle of rights *vis-*

⁵⁰ (1976), 22 C.B.R. (N.S.) 207 at 212 (Ont. S.C.).

⁵¹ *Supra* note 37.

⁵² *Supra* note 35.

⁵³ This is the term used in the Canadian PPSAS, *supra* note 7, and in the United States *Uniform Commercial Code*.

à-vis the collateral, conferred by the provincial statute under which the interest arises.⁵⁴ Although a real property mortgage in a non-Torrens jurisdiction entails a formal transfer of title to the collateral by the mortgagor to the mortgagee, the mortgagee's legal title is limited by the debt it secures. The mortgagor's equity of redemption has been described by the Supreme Court of Canada in terms indicating that the modern common law mortgage constitutes no more than a charge on the mortgagor's fee simple estate or title.⁵⁵

In *Bye* and *Re Pelyea*, the nature of the collateral claimed by the secured creditors was such that property in existence at the date of discharge was clearly distinguishable from property acquired by the debtor after his discharge from bankruptcy. Since the debt founding the secured parties' claims was released by discharge, it clearly could not thereafter support the creation of a security interest, which by definition could not arise until the property claimed by the creditors as collateral was acquired. The problem of ascertaining the extent of a secured creditor's rights of realization is, however, more difficult when the property in question cannot be readily categorized in units acquired before or after the date of discharge.

In some cases involving a secured creditor's claim against an item of property in existence at the date of the debtor's discharge, there appears to be a troubling judicial predisposition to improperly extend the principles established in *Bye* and endorsed in *Re Pelyea*. The question such cases present is whether survival of the security interest entitles a secured creditor to recover pre-discharge debt from appreciation in the value of either the item of collateral or the debtor's equity in the

⁵⁴ Cuming & Wood, *supra* note 3 at 22, suggest that the PPSA security interest is comparable to the common law equitable charge and the Roman hypothecation or hypothec. Both conceptual devices represent a right to resort to the collateral for payment to the extent of the debt secured. Though the right is therefore proprietary in nature, it is not a right of ownership. See also R.C.C. Cuming, "The Internationalization of Secured Financing Law: The Spreading Influence of the Concepts of the UCC, Article 9 and its Progeny" in R. Cranston, ed., *Making Commercial Law: Essays in Honour of Roy Goode* (Oxford: Clarendon Press, 1997) 597; and E.I. Sykes & S. Walker, *The Law of Securities*, 5th ed. (New South Wales: Law Book, 1993) at 14. With respect to a mortgage of land under a Torrens land registration system of real property law, see Roach, *supra* note 3 at 8-16.

⁵⁵ See *Petranik v. Dale*, [1977] 2 S.C.R. 959 at 986. A mortgagee's rights of foreclosure derive from the right to recover the secured debt. If the collateral is worth more than the debt it secures, the mortgagee will be required to sell the property, remitting the surplus proceeds to the debtor or subordinate mortgagees claiming an interest in the equity of redemption. The mortgagee will not be permitted to deprive the mortgagor of property in excess of the amount of the debt, since this would result in the appropriation of the debtor's equity of redemption: see Roach, *supra* note 3 at 93-94.

collateral. In my opinion, the answer dictated by the legal doctrine founding these decisions is no.

In *Andrew v. FarmStart*,⁵⁶ the unqualified proposition that a security interest in a bankrupt's property survives the bankrupt's discharge led the Saskatchewan Court of Appeal to allow a mortgagee to appropriate what was, in substance, property acquired by a bankrupt after his discharge. This decision appears to manifest the Court's failure to consider the limited nature of a secured creditor's proprietary rights in the debtor's property.

In *FarmStart*, a parcel of land owned by the bankrupt was subject to three mortgages, the first two of which secured debts that were together in excess of the value of the land. FarmStart, the governmental lending agency holding the third mortgage on the land, accordingly filed in the bankruptcy as a preferred creditor, on the basis that the value of its security was nil. A small dividend was paid on its claim, and the bankrupt was discharged. The debts secured by the first and second mortgages were thereafter paid, and the mortgages discharged. When the bankrupt subsequently sold the land, FarmStart asserted a claim to the proceeds on the basis of its mortgage, which was still registered against the title. Having concluded, after some discussion, that the filing of a proof of claim and acceptance of a dividend did not in the circumstances constitute a surrender of security, the majority of the Court went on to hold that FarmStart was entitled to assert its claim as mortgagee on the ground that "[a] secured creditor may realize upon his security after discharge of the bankrupt."⁵⁷

With respect, the Court of Appeal in *FarmStart* failed to recognize that the third mortgagee had no proprietary interest in the bankrupt's property at the time of discharge, because its claim against the title as security was devoid of content. Although the mortgagee's registration of its claim against the debtor's title might have attracted statutory procedural rights, that fact does not entail the creation of a substantive interest.⁵⁸ The value of the land was fully encumbered by the first and second mortgages. There was simply no "property" left against

⁵⁶ (1988), 71 C.B.R. (N.S.) 124 (Sask. C.A.) [hereinafter *FarmStart*], leave to appeal to S.C.C. refused (1989), 73 C.B.R. (N.S.) xxvii.

⁵⁷ *FarmStart*, *supra* note 56 at 139.

⁵⁸ *FarmStart* was decided in Saskatchewan under a Torrens registry system of real property law. The effect of registration is also pertinent to the claim of a creditor who has registered a security interest in personal property in a provincial PPSA registry. Though registration as a "secured creditor" entitles that claimant to such procedural rights as notice of sale by prior secured creditors, it cannot confer a proprietary interest where no property is available to satisfy the right to payment constituting the statutory charge.

which the third mortgagee could assert a claim. FarmStart therefore did not have an interest that could *survive* the bankrupt's discharge because it had no interest at *the time of* his discharge. Its claim rested on an unsecured debt which, by virtue of the operation of section 178(2), was released by the discharge and could not be revived through the assertion of a non-existent security interest. This conclusion is clearly mandated by the decision in *Re Pelyea*, which was quoted by the Saskatchewan Court of Appeal in support of its apparently contradictory decision in *FarmStart*.

The same issue was raised in the Ontario case of *Patrie v. Royal Bank*,⁵⁹ on facts directly paralleling those in *FarmStart*, except that the collateral in issue was an automobile rather than land. Ferguson J. denied the post-discharge attempt of a bank that had registered a security interest against the vehicle to exercise rights of realization. The attempted recovery was denied on the ground that, at the time of the bankrupt's discharge, there was no property to which the interest could have attached. The value of the collateral was fully encumbered by a prior security interest. Although the Court's reasoning is cursory, it quoted and properly applied *Re Pelyea* as authority for its decision.

The same result should follow in the case of property owned by the bankrupt at the date of discharge, with respect to any appreciation in its value following discharge. If the land in *FarmStart* had remained subject to the first and second mortgages but, following the discharge, appreciated to a value in excess of the debts secured by them, a post-bankruptcy claim by the third mortgagee would be similarly unfounded.

This reasoning is also relevant to the claim of a creditor under a security agreement that confers a security interest in after-acquired property. Clearly, a security interest securing a pre-discharge debt cannot attach to assets acquired by the debtor after his or her discharge from bankruptcy, notwithstanding the wording of the security agreement or the fact of registration of the creditor's claim. The debt is either extinguished or rendered unenforceable by the discharge. It cannot, therefore, support a post-discharge proprietary interest. The reasoning in *FarmStart*, however, would lead to the contrary result.⁶⁰ If a security interest can attach to new property acquired by the debtor in the form of increased equity in the subject collateral, an interest in after-acquired property can presumably attach to new assets caught by an after-acquired property clause.

⁵⁹ (1994), 27 C.B.R. (3d) 89 (Ont. Ct. (Gen. Div.)).

⁶⁰ The significance of the *FarmStart* decision is, unfortunately, magnified by the fact that an application for leave to appeal was refused by the Supreme Court of Canada: see note 56, *supra*.

The view that post-discharge increases in value or equity are after-acquired property to which a security interest founded on pre-discharge debt cannot attach is most compelling in connection with Torrens system mortgages and PPSA security interests. However, the substantive similarities between the proprietary interest held by a common law mortgagee of land, and the charge held by a Torrens system mortgagee or PPSA secured creditor, justifies application of the same reasoning in non-Torrens jurisdictions. Though the common law mortgagee formally holds title to the land, the interest is clearly limited to the right to recover the debt supporting the mortgage. The mortgagee's equity of redemption so qualifies the mortgagee's proprietary interest that, functionally, it operates in the same way and represents the same kind of claim as does the statutory charge of the Torrens mortgagee. The common law mortgagee does not hold unqualified rights of "ownership" that would entitle the mortgagee to assert a claim against whatever value the land might have from time to time.

Where a creditor asserts rights of realization against post-discharge appreciation in the value of collateral or in the value of the debtor's equity, determination of the validity and extent of that assertion will require valuation of the property claimed as at the date of discharge. This is not an enormous problem if the collateral has a market value that can be ascertained or at least approximated at any given point in time. However, the decision of the Saskatchewan Court of Appeal in *Chetty v. Burlingham Associates Inc.*⁶¹ demonstrates the problems of valuation that may arise in connection with some forms of intangible collateral.

In *Chetty*, the Court considered the claim of a bank to a security interest in fees paid to a lawyer after his discharge, pursuant to a contingency agreement made before his bankruptcy. The Court concluded that the bank was entitled to the fees on the basis of its security interest in the bankrupt's accounts, since "an absolute discharge in bankruptcy does not prevent a secured creditor from pursuing its security."⁶² This decision is correct if the value of the chose representing the bankrupt's right to payment was, at the date of his discharge, equivalent to the amount of the contingency fee ultimately paid. However, as at the date of discharge the account might be viewed as worthless, since there was no assurance a fee would ever be paid. The problem of valuation is not addressed by the court.

⁶¹ (1995), 121 D.L.R. (4th) 297 (Sask. C.A.) [hereinafter *Chetty*], leave to appeal to S.C.C. refused (1995), 126 D.L.R. (4th) vii.

⁶² *Chetty*, *supra* note 61 at 307, citing *FarmStart*, *supra* note 56.

If the courts in Saskatchewan or elsewhere continue on the path set by *FarmStart*, secured creditors may congratulate themselves on their remarkable good fortune. Faced with their debtor's bankruptcy, creditors whose security is valueless due to the existence of prior encumbrances may prove their claim as an unsecured creditor and take whatever is available by way of dividend. They may then simply wait until prior secured claims are paid off, at which time they may seize the collateral in satisfaction of the remaining balance of what was, at the date of the debtor's bankruptcy, an unsecured debt. This course of action entails the risk that the secured creditor adopting it might be deemed to have surrendered his or her security to the trustee, thereby precluding its subsequent enforcement. However, recent cases, including *FarmStart* itself, suggest that the risk is minimal, since the filing of a proof of claim and even the acceptance of a dividend will not necessarily be regarded as conclusive evidence of a surrender of security.⁶³

Whether or not it is technically wrong, some would contend that the outcome in *FarmStart* is defensible as a matter of policy. One might argue that a person who takes a security interest in property knowing that the debtor's interest is fully encumbered does so in anticipation of the potential creation of equity supporting his or her security, either through appreciation of the property or through the discharge of the prior security interests. This view carries some weight in connection with the advance of credit secured by an interest in property that may be expected to appreciate in value.

On the other hand, credit advanced on the basis of a subordinate security interest or deficient collateral value is presumably advanced on terms reflecting the limited likelihood that it may be repaid through realization. Creditors with enough sophistication to require security will or should know that their security may ultimately prove to be of insufficient or no value, depending on the vagaries of the real estate market and other variables, including the potential bankruptcy of the debtor.

Some pertinent observations are made by the authors of a respected study of consumer bankruptcy in the United States.⁶⁴ In their examination of the role of secured credit in consumer bankruptcy, they note that nominally secured credit offered by large and experienced financial institutions is often significantly undersecured, exposing those lenders to the risk of considerable losses in the foreseeable event of their

⁶³ See *FarmStart*, *supra* note 56; and *Re Pelyea*, *supra* note 37.

⁶⁴ See T.A. Sullivan, E. Warren & J.L. Westbrook, *As We Forgive Our Debtors: Bankruptcy and Consumer Credit in America* (New York: Oxford University Press, 1989) at 282-92.

debtors' bankruptcies. This is true of loans advanced to the proprietors of small businesses, as well as those qualifying as strictly consumer loans. They point out that this apparently prevalent course of action on the part of American lenders is explicable if the loans advanced on this basis are sufficiently profitable to justify assuming an appreciable risk of loss.⁶⁵ Simply put, lenders appear to be prepared to advance credit knowing full well that their security may not support recovery of the debt in the event of default or bankruptcy.

Since the observations and inferences advanced by these authors are supported by American statistics, they may not be directly relevant to the Canadian credit market. However, if in fact creditors are prepared to advance ostensibly secured credit on an undersecured or even effectively unsecured basis, knowing full well that the likelihood of full recovery in the event of default is uncertain at best, the standard rationales for the preferential treatment of secured creditors (*i.e.*, protection of voluntary risk allocations and minimization of the cost of credit) are of little consequence in this connection.

William Whitford argues that post-discharge reaffirmations of debt owed by consumers to secured creditors should be permitted in the United States, in at least some circumstances, for reasons of policy.⁶⁶ Such reaffirmation would, of course, be accompanied by a right to enforce the security interest securing the debt. It is not clear whether the policy arguments he advances are persuasive in the different context of the Canadian credit market, since there are no data demonstrating the impact of post-discharge enforceability on interest rates or creditor practices. In any event, there is nothing in Canadian bankruptcy law to preclude contractual reaffirmations. What is objectionable is the judicial imposition of outcomes that impose reaffirmation through post-discharge enforcement of statutorily released debt, either by way of *in personam* enforcement of deficiency claims on the tenuous ground of "continuation" of the contractual relationship, or through the approval of realization against property value acquired after discharge.

Regardless of whether policy arguments based on assumptions about creditor practices and the cost of borrowing would, on balance, support or deny post-discharge enforcement of secured creditors' rights, these policy considerations cannot validate judicially mandated

⁶⁵ Theresa Sullivan, Elizabeth Warren, and Jay Lawrence infer from their analysis of the data presented that the most knowledgeable lenders engage in high-risk lending, suggesting that loan losses are part of a larger balance of risk and return: see *ibid.* at 290.

⁶⁶ See W.C. Whitford, "Secured Creditors and Consumer Bankruptcy in the United States" (1999) 37 Osgoode Hall L.J. 339.

outcomes that are contrary to the provisions of the *BIA* and the doctrinal underpinnings of relevant provincial law. Until such time as the fresh start demanded by section 178(2) of the *BIA* is qualified by statutory amendment, creditor realization against property acquired by a debtor after a discharge from bankruptcy is improper.

III. SECURED CREDITORS AND CONSUMER PROPOSALS

The 1992 consumer proposal provisions found in Part III, Division 2 of the *BIA*⁶⁷ are designed to enable consumer debtors to restructure their payment obligations through binding composition agreements with their creditors. However, those provisions leave secured creditors virtually untouched, unless they elect to subject themselves to the terms of a proposal. Though a consumer proposal may address the payment of secured claims, an approved proposal is binding on secured creditors only in respect of secured claims that have been voluntarily made subject to its terms through the filing of a proof of claim.⁶⁸ A creditor who files a proof of a secured claim is bound by the proposal if it is approved by the general body of creditors.⁶⁹ If a secured creditor chooses not to file a proof of claim, there is nothing to prevent or qualify the exercise of the creditor's rights of realization, provided that the debtor is in default under the security agreement.

Once a consumer proposal has been filed, section 66.34(1) prevents the termination of a security agreement or the acceleration of payments due through the operation of a contractual definition of default that would trigger those events upon the debtor's insolvency or the filing of a proposal. However, if default is otherwise established, secured creditors may realize against their security, free of the general stay precipitated by the filing of a consumer proposal.⁷⁰ Section 69.2 specifically recognizes secured creditors' rights of realization in terms identical to those applicable to them under section 69.3 in cases of outright bankruptcy.

⁶⁷ See *BIA*, *supra* note 1, ss. 66.11-66.40, as am. by *1992 Amendments*, *supra* note 4, s. 32(1).

⁶⁸ *Ibid.* s. 66.28(2)(b).

⁶⁹ *Ibid.* ss. 66.18(1), 66.19(1). Section 66.12(4)(b) of the *Act* provides that a secured creditor may respond to a consumer proposal by filing with the administrator a proof of claim in the manner provided for in sections 124-134, which are the provisions otherwise applicable to the proof of claims by secured creditors in cases of outright bankruptcy.

⁷⁰ *Ibid.* s. 69.2.

It is difficult to imagine circumstances in which a secured creditor would choose to be subject to the opinion of the majority of general creditors. Non-participation preserves all the secured creditor's rights of realization without precluding the secured creditor from challenging the proposal before a court, should the creditor perceive it to be prejudicial to its interests. The filing of a proof of claim would be advantageous only to an undersecured creditor who wishes to establish the unsecured portion of the claim so that it may participate in the payments to unsecured creditors.⁷¹ Secured creditors can, and do, file a proof with respect to the unsecured portion of their claim, while retaining their rights of realization against the collateral, free of the terms of the proposal.

There appears to be no case law challenging a secured creditor's right to sue for any deficiency, or unsecured portion of the debt, on the basis of the approval or completion of a consumer proposal in which the secured creditor has not participated. Cases that address proposals falling within what is now Part III, Division 1 of the *BIA* confirm that a proposal operates as a contract of settlement or compromise, albeit one imposed by the statute on dissenting creditors.⁷² If a secured creditor has not brought a claim within the application of the proposal, one might therefore contend that neither the rights of realization nor the right to enforce the unsecured portion of the debt is subject to any contractual or quasi-contractual satisfaction imposed by it.

However, section 66.28(2) contradicts this conclusion. It provides that an accepted consumer proposal is binding upon "(a) all unsecured claims, and (b) secured claims for which proofs of claim have been filed." The provision is referable, not to the class of creditor asserting a claim as either secured or unsecured, but to the character of the claim affected by the proposal. One might legitimately contend that the unsecured portion of a debt, determined as at the time of the filing of the proposal, is therefore subject to its terms.⁷³ Performance of the proposal should thus be viewed as satisfying the unsecured claim, even if the creditor has not filed a proof of claim and accordingly has not

⁷¹ Section 66.4, *ibid.*, provides that all the provisions of the *Act*, except Part III, Division 1 apply with such modifications as may be required to consumer proposals. The filing of a proof of claim is accordingly necessary to establish an entitlement to the payments contemplated by the proposal, which may be analogized to the "dividends" payable by a trustee in a bankruptcy.

⁷² See, for example, *Employer's Liability Assurance Corp. Ltd. v. Ideal Petroleum (1959) Ltd.*, [1978] 1 S.C.R. 230.

⁷³ Section 66.28(1) of the *BIA*, *supra* note 1, provides that the time with respect to which the claims of creditors shall be determined is the time of the filing of the consumer proposal.

received any payment. While this view raises potential problems in determining the value of the collateral at the date of the proposal, these difficulties are no greater than those arising in connection with quantification of the deficiency claim released by a debtor's discharge from bankruptcy.

As a practical matter, secured creditors are in a position to dominate or defeat any effort at financial rehabilitation through the formulation of a consumer proposal. The preservation of secured creditors' rights of realization independent of a proposal means that the consumer must give priority to the maintenance of payments required to keep security agreements in good standing, thereby preventing seizure of collateral that plays an important or even essential role in his or her personal or business life. The need to channel available income to a very few creditors undoubtedly means that many financially crippled consumers are unable to make a meaningful attempt to satisfy unsecured claims. Since a consumer's bankruptcy poses little threat to the position of a well secured creditor, the creditor may have little incentive to accommodate the successful completion of a proposal as an alternative to outright bankruptcy.

IV. PROVINCIAL LIMITATIONS ON SECURED CREDITORS' RIGHTS

Bankruptcy law as such falls within federal constitutional jurisdiction.⁷⁴ However, provincial laws governing matters of property and civil rights interface with federal bankruptcy law at several important junctures. The provincial definition of the rights ascribed to those holding security interests in real and personal property, respectively, provides the legal content underlying the terms "secured creditor," "security," and associated language employed by the *BIA*. Differences among the statutory regimes of the provinces and territories make absolute generalizations impossible. However, the law of most provinces potentially affects the exercise of secured creditors' rights against a bankrupt consumer and his or her property in at least two notable respects.

⁷⁴ See *Constitution Act, 1867*, *supra* note 2, s. 91(21).

A. *Defeat of Unperfected Security Interests in Personal Property by the Trustee*

The territories and all of the provinces other than Quebec and Newfoundland have adopted a PPSA.⁷⁵ This legislation regulates the creation, enforcement, and priority ranking of security interests in personal property in comprehensive terms and, in so doing, defines a "secured creditor" and delineates its fundamental rights.

The rights of realization conferred upon secured creditors by provincial law are essentially unaffected by the debtor's bankruptcy. However, one PPSA provision operates exclusively in bankruptcy to defeat a secured creditor's right to take the bankrupt's property in satisfaction of the secured debt. That provision prescribes that a security interest in collateral that is not perfected at the date of bankruptcy is not effective against the trustee in bankruptcy.⁷⁶ This provision entitles a trustee in bankruptcy to take collateral subject to an unperfected security interest and distribute its proceeds free of that interest. In effect, this enables the trustee to exercise on behalf of unsecured creditors their pre-bankruptcy right to defeat an unperfected security interest in prescribed circumstances.⁷⁷

While this result thwarts the secured creditor, it will not materially affect the consumer bankrupt in most cases. If the secured creditor would otherwise have realized its security interest, the loss of the collateral to the trustee is of no consequence unless the proceeds are applied to reduce non-dischargeable debt. If the secured creditor would have refrained from seizure in the expectation that payments would be

⁷⁵ See note 7, *supra*. In Quebec, the rights of secured creditors are defined in distinctive terms by the *Civil Code of Quebec*, S.Q. 1991, c. 64; and the *Code of Civil Procedure*, R.S.Q. 1977, c. C-25.

⁷⁶ See, for example, *PPSA (B.C.)*, *supra* note 7, s. 20(b)(i). Under the PPSAs of all provinces but Ontario, this provision extends to chattel leases for a term of more than one year. In *Re Giffen*, [1998] 1 S.C.R. 91, it enabled the trustee of a bankrupt lessor to take the vehicle subject to the lease in priority to the lessee, whose interest is characterized by the *Act* as a deemed security interest. The security interest was unperfected by virtue of the lessee's failure to register it in the personal property security registry.

⁷⁷ Outside bankruptcy, this is accomplished by taking judgment enforcement measures against property of the debtor: see, for example, *PPSA (B.C.)*, *supra* note 7, s. 20(a). Such measures are precluded after the debtor's bankruptcy by the automatic stay: see *ibid.* s. 69.3(1). For a discussion of this rationale, see *International Harvester Credit Corp. of Canada v. Bell's Dairy Ltd.* (1986), 61 C.B.R. (N.S.) 193 (Sask. C.A.); and *Re Giffen*, *supra* note 76.

maintained, the consumer may be disadvantaged by the loss of the collateral to his or her unsecured creditors.⁷⁸

A secured creditor whose debtor has made a consumer proposal instead of declaring bankruptcy is not affected by this provision, because it operates only in favour of a "trustee in bankruptcy."⁷⁹ There is therefore no substantive basis upon which the claim of a creditor whose security interest is unperfected can be challenged by the administrator of a consumer proposal. Since unsecured creditors are subject to the stay imposed by section 69.2(1) upon the filing of a proposal, they are precluded from defeating the unperfected security interest by seizing the collateral through judgment enforcement measures. The holder of an unperfected security interest is therefore much better served by the making of a consumer proposal than by the debtor's bankruptcy.

B. *The Role of Provincial Exemptions Law and Statutory Restrictions on Seizure*

The exemptions legislation of the provinces serves chiefly to exempt identified items of property from seizure under execution.⁸⁰ Though it operates in a debtor's favour within, as well as outside, bankruptcy, it does not directly affect the position of secured creditors, since it generally does not preclude seizure of the debtor's assets for purposes of security realization.⁸¹

⁷⁸ If the item in question is exempt from seizure under provincial law, the secured creditor's rights will not be affected by the PRSA provision under discussion: see Part IV(B), below.

⁷⁹ See, for example, *PPSA (B.C.)*, *supra* note 7, s. 20(b)(i).

⁸⁰ Exempting provisions are contained in a range of statutes under a variety of names. Most apply to seizures under legal processes identified as "execution," though some use other terminology designating judgment enforcement measures more generally. The following are the pertinent provincial statutes: Alberta, *Civil Enforcement Act*, S.A. 1994, c. C-10.5; British Columbia, *Court Order Enforcement Act*, R.S.B.C. 1996, c. 78, ss. 71, 72; British Columbia, *Homestead Act*, R.S.B.C. 1996, c. 197, s. 4; Manitoba, *Executions Act*, R.S.M. 1987, c. E160; New Brunswick, *Memorials and Executions Act*, R.S.N.B. 1973, c. M-9, s. 33; Nova Scotia, *Judicature Act*, R.S.N.S. 1989, c. 240, s. 45; Ontario, *Execution Act*, R.S.O. 1990, c. E-24; Prince Edward Island, *Judgment and Execution Act*, R.S.P.E.I. 1988, c. J-2; Quebec, *Code of Civil Procedure*, *supra* note 75, arts. 552-553.2; Saskatchewan, *The Exemptions Act*, R.S.S. 1978, c. E-14; Saskatchewan, *The Saskatchewan Farm Security Act*, S.S. 1988-89, c. S-17.1, ss. 65, 66; Northwest Territories, *Exemptions Act*, R.S.N.W.T. 1988, c. E-9, s. 2; and Yukon Territory, *Exemptions Act*, R.S.Y. 1986, c. 59, s. 2.

⁸¹ The Saskatchewan *Exemptions Act*, *supra* note 80, may be regarded as an exception in that it allows a debtor to claim as exempt from seizure and sale under a security agreement the chattels that are exempt from seizure under execution, subject to a purchase money security interest proviso.

A variety of provincial statutes do impose modest restrictions on secured creditors' rights to seize collateral. Since they apply equally to the exercise of rights of realization within and outside of bankruptcy, they merit only cursory review in an examination of secured creditors' rights in bankruptcy.

No province or territory precludes seizure of real property by way of mortgage foreclosure or other security enforcement proceedings. Only four provinces absolutely prohibit the seizure of identified kinds of essential personal goods by secured creditors,⁸² and those prohibitions generally protect personal assets only to the extent of a relatively small dollar value. Furthermore, they generally do not apply to purchase money financiers. In a number of provinces, PPSA provisions protect consumer goods from seizure if loss of the goods would cause serious hardship to the debtor, or if the debtor has paid most of the total debt secured.⁸³

Provincial statutes exempting property from seizure under execution can operate to boost the position of a secured creditor holding an unperfected security interest in such property in PPSA jurisdictions. The exempt property that is subject to the security interest is excluded from distribution as part of the bankrupt debtor's estate by section 67(1)(b) of the *BLA*. The trustee is thus unable to seize that property. If no provincial statute precluding seizure of the collateral by secured creditors affects the item of property in question, the secured creditor will be able to realize its security interest. Had the property not been exempt, the provincial PPSA would render the security interest "ineffective" against the trustee in bankruptcy, enabling the trustee to take the collateral in priority to the secured creditor.

Limitations on seizure are also imposed by "seize or sue" legislation in six provinces and the territories.⁸⁴ In general, such

⁸² See *ibid.*; *PPSA (N.B.)*, *supra* note 7, s. 58; *PPSA (N.S.)*, *supra* note 7, s. 59; and *PPSA (P.E.I.)*, *supra* note 7, s. 58.

⁸³ See *PPSA (N.B.)*, *supra* note 7, ss. 58(3)(d), 58(4); *PPSA (N.S.)*, *supra* note 7, ss. 59(3)(d), 59(4); *PPSA (P.E.I.)*, *supra* note 7, ss. 58(3)(d), 58(4); *PPSA (B.C.)*, *supra* note 7, s. 58(3); Manitoba, *Consumer Protection Act*, R.S.M. 1987, c. S200, ss. 49, 57 [hereinafter *CPA (MAN.)*]; Yukon, *Consumer Protection Act*, R.S.Y. 1986, c. 31, ss. 49, 57 [hereinafter *CPA (Y.)*]; Northwest Territories, *Consumer Protection Act*, R.S.N.W.T. 1988, c. C-17, ss. 60, 67 [hereinafter *CPA (N.W.T.)*].

⁸⁴ See *CPA (MAN.)*, *supra* note 83, s. 53; Newfoundland, *Conditional Sales Act*, R.S.N. 1990, c. C-28, s. 13; Newfoundland, *Bills of Sale Act*, R.S.N. 1990, c. B-3, s. 15; *CPA (N.W.T.)*, *supra* note 83, s. 64; *CPA (Y.)*, *supra* note 83, s. 53; Alberta, *Law of Property Act*, R.S.A. 1980, c. L-8, s. 49 (all re-en. 1988, c. P-4.05, s. 87; s. 49 am. 1991, c. 21, s. 18); and *PPSA (B.C.)*, *supra* note 7, s. 67. The Saskatchewan *Limitation of Civil Rights Act*, R.S.S. 1978, c. L-16, s. 18 (as am. by S.S. 1979-80, c. 29, s. 3; 1988-89, c. 52, s. 12(7); 1992, c. 43, s. 3(2)) imposes a seize-only regime.

legislation prevents a seller of goods from both realizing a security interest taken in the goods to secure the seller's purchase price, and suing on the debt to recover a deficiency. However, the scope and mechanics of the various statutes limiting secured creditors' rights in this manner differ.⁸⁵ None of this legislation imposes a significant hardship on secured creditors whose debtors have become bankrupt, since their rights of realization against the collateral are, in any event, much more valuable in a bankruptcy than any ability to enforce the debt itself. The likelihood of any meaningful recovery on unsecured debt is notoriously slight.

V. CONCLUSION

The conclusions to be drawn from the foregoing discussion are fairly obvious. Secured creditors dealing with a bankrupt debtor, or a debtor whose financial disability has prompted the making of a consumer proposal, enjoy the best of two worlds. Most importantly, they may recover the portion of their debt secured by the debtor's property through direct realization measures, unimpeded by the *BIA*. Bankruptcy law neither limits secured creditors' rights of realization, nor subjects them to any involuntary adjustment of repayment schedules. Though provincial law imposes some restrictions on secured creditors' rights of realization, they are no more onerous after the debtor's bankruptcy than before. In addition, secured creditors may participate in distributions available under a bankruptcy or proposal with respect to the unsecured portion of the debt in the same manner as fully unsecured creditors.

The preservation of rights of realization after the debtor's discharge from bankruptcy places secured creditors in a particularly powerful position. It enables them to renegotiate the credit agreement, providing for post-bankruptcy payment of unsecured, as well as secured, debt as the price of their forbearance from seizure of the collateral. Such agreements are not subject to judicial supervision or statutory regulation.

We have seen that these rights have been extended by judicial decisions addressing post-discharge enforcement of the security interest and of the debtor's personal obligation to pay. Some courts have allowed the realization of a security interest in equity acquired by the debtor after his or her discharge. Others have endorsed post-discharge enforcement of the debt. While both outcomes are insupportable as a

⁸⁵ See *ibid.*

matter of both law and policy, there is currently no obstacle to further extension of the lines of authority sustaining them.

Secured creditors fare as well under consumer proposals as they do in an outright bankruptcy. The fact that they are subject to the terms of a consumer proposal only if they elect to participate means that such proposals cannot be used effectively as a device to restructure payment schedules on secured loans, or to delay or prevent the seizure of assets. Current administrative and statutory policy is designed to promote the use of consumer proposals as an alternative to bankruptcy,⁸⁶ apparently in the hope of achieving higher levels of debt repayment as well as debtor rehabilitation. One may infer that these policies are, in part, a response to the common charge that bankruptcy law is "soft" on debtors. Regardless of motivation, the objective of achieving successful consumer proposals is likely to be thwarted so long as secured creditors are excluded.

This situation may be regarded as tolerable, on the view that secured creditors' rights are no better in bankruptcy or under a consumer proposal than they would have been had those circumstances not arisen. Bankruptcy law simply preserves the rights to which secured creditors are in any event entitled. However, the force of that rationale is considerably weakened by the juxtaposition of secured creditors' rights with those of unsecured creditors. Bankruptcy law is fully prepared to tinker with—or even obliterate—the rights of unsecured creditors, while leaving secured creditors unscathed. It is not self-evident that the rights of secured creditors should be preserved in bankruptcy, while those of unsecured creditors should not. No one doubts that the objectives of debtor rehabilitation and equitable treatment of creditors justify wholesale intervention in the legal position of unsecured creditors. Rather remarkably, it appears that little attention has been paid, at least by government, to the question of whether those objectives similarly justify some modification of secured creditor rights, particularly in the context of consumer bankruptcy.

⁸⁶ If, in the opinion of the court, a bankrupt could have made a viable proposal, but "chose bankruptcy ... as a means to resolve the indebtedness," an absolute discharge must be refused: see *BIA*, *supra* note 1, ss. 172, 173(1)(n).