

Fraud and Knowledge of a Pre-Existing Security Interest under the *Personal Property Security Act*: Guidance from Other Jurisdictions for Manitoba Courts and Practitioners

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I. INTRODUCTION

In the context of secured transactions, can one take advantage of the mistake of another? It is this question with which this article is concerned. This article arose out of a conversation between the authors in which both of us realized that insofar as either of us could find, there was no jurisprudence under the Manitoba *Personal Property Security Act*¹ to resolve this issue. Yet, two points were clear. The first was that this issue was important, both from the point of view of practitioners and their clients, and from the point of view of academics teaching the subject to students. Secondly, there is jurisprudence from other Western Canadian jurisdictions that could shed some light and help to fill this gap.

This article begins by setting out some of the basic principles and policy rationales underlying the PPSA. Also, we refer to certain provisions of the PPSA which demonstrate these principles. As will become evident, these principles often come into conflict. Nonetheless, the Courts tend to resolve this conflict on a case-by-case basis, rather than laying down any hard-and-fast rules about which principle must always give way to the other, which could potentially be exploited in the future by unscrupulous parties.² Finally, the authors will bring together some of the lessons that can be learned from these cases taken as a whole.

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¹ CCSM, c P35 [the "PPSA"].

² As was held by the British Columbia Court of Appeal in *Gallen v Allstate Grain Co Ltd* (1984), 9 DLR (4th) 496 at p 510, 53 BCLR 38 (*sub nom Gallen v Butterley*), the rules of the common law were never meant to be used as tools to allow "the unscrupulous to dupe the unwary". While the PPSA is statutory, as we will see below, there is an equivalent principle at play.

II. THE PROBLEM

The issue to be resolved in this paper can be illustrated by the following hypothetical fact-scenario: we have a debtor, who wishes to borrow money. Creditor #1 is willing to do so, but only if the debtor offers security.³ In return for the advance of the loan, Creditor #1 receives a security interest⁴ in some or all of the personal property of the debtor. In order to perfect the security interest,⁵ the Creditor #1 must register a financing statement in a public registry.⁶ Creditor #1 does so, but does so improperly, such that the registration is ineffective.⁷ Creditor #2 comes along, having lent money to the debtor, and received a security interest in the same collateral⁸ as Creditor #1. Creditor #2 is aware of Creditor #1's security interest. However, Creditor #2 discovers that Creditor #1's registration is invalid and proceeds to register a financing statement against the same collateral as Creditor #1. Should Creditor #2 rank ahead of Creditor #1 in a priority competition⁹ with respect to the collateral?

³ Security is a right given to the creditor to seize and sell pieces of the property belonging to the debtor to ensure repayment of the obligations of the debtor to the creditor.

For those readers unfamiliar with the basics of secured transactions law, the authors suggest an examination of one or more of the following texts on the subject. See, for example, Ronald CC Cuming, Cathrine Walsh, and Roderick J Wood, *The Essentials of Canadian Law – Personal Property Security Law* (Toronto: Irwin Law, 2005) [Cuming, Walsh and Wood], Anthony J Duggan and Jacob S Ziegel, *Secured Transactions in Personal Property and Suretyships : Cases, Text and Materials*, 5th ed (Toronto: Emond Montgomery Publications Ltd, 2009), or Richard H. McLaren, *Secured Transactions in Personal Property*, 3d ed (Toronto: Carswell, looseleaf).

⁴ A security interest includes an interest in the debtor's personal property which is designed to secure the repayment of the loan. See the PPSA, *supra* note 1, s 1. Other interests are also included in the definition, but these are not particularly relevant for current purposes.

⁵ To “perfect” a security interest is to take the best position a creditor is allowed by law to take with respect to the asset. In general, a perfected security interest ranks ahead of any security interest that is not perfected. See the PPSA, *supra* note 1, s 35.

⁶ “Financing statement” is the publicly available document that is designed to tell all interested parties that a creditor (in this case, both Creditor #1 and Creditor #2) has taken a security interest in property of the debtor.

⁷ In general, an ineffective registration is treated as no registration at all, because it will not provide effective notice to third parties, which is the point of the registration system. Also, in general, the first party to take the perfecting step (in this case, registration of a financing statement) will generally rank ahead of later registrants. See the PPSA, *supra* note 1, s 35(1).

⁸ “Collateral” is the personal property of the debtor that is subject to the security interest. See PPSA, *supra* note 1, s 1.

⁹ A priority competition is best explained as follows. As is implicit in the above recitation, a debtor may give security interests to two or more secured party creditors. Therefore, when there are two otherwise valid claims to a given piece or pieces of property, a priority competition arises. As one of the authors has explained elsewhere: “‘Priority’ is a term that describes the ranking of claims in a single piece of property. The easiest analogy is that of a line. A person who wins a priority competition will be in line ahead of the person who loses that competition. When the asset is sold to pay the various claimants to the asset, the value received on the sale will go to the winner of priority competition first. If there is residual value remaining in the asset following the

III. PRINCIPLES AND STATUTORY PROVISIONS

As in many areas of the law, the short answer is “sometimes”. As unsatisfactory as such an answer may be (from the point of view that predictability of the outcomes of legal questions should be an important feature of our legal system), it is necessary to keep in mind several policy concerns and statutory rules and principles found in the PPSA:

- a) generally, the PPSA’s rules are intended to establish a regime where the resolution of the priority of competing security interests can be clearly and easily determined by the parties themselves. The more certainty that exists in the system as to such resolution, the fewer the barriers to the advance of credit, and the more smoothly that the credit market can operate;¹⁰
- b) the rights, duties and obligations arising under a security agreement, under the PPSA or under any other applicable law shall be exercised or discharged in good faith and in a commercially reasonable manner;¹¹ and
- c) a person does not act in bad faith merely because the person acts with knowledge of the interest of some other person;¹²
- d) the principles of common law, equity and the law merchant, except insofar as they are inconsistent with the provisions of the PPSA, supplement the PPSA and continue to apply.¹³

Given all this, should Creditor #2 end up with an unexpected benefit, advantage or windfall?

Clearly, the first and third of the above quoted “rules” would appear to allow Creditor #2 to keep an unexpected benefit where Creditor #2 knew of the existence of Creditor #1’s security interest and Creditor #2 took advantage of Creditor #1’s failure to register properly. If Creditor #2 knew enough to do the search and registration, it is also probable Creditor #2 knew that Creditor #2’s registration would rank ahead of Creditor #1’s interest, because Creditor #1 did not register properly.

repayment in full of the obligation owed to the winner of the priority competition, then the person second “in line” would receive the residual value. The process would then repeat itself, until either: (i) the residual value of the asset is completely exhausted, or (ii) all creditors with a valid security interest in the asset were repaid in full. Therefore, simply because the creditor wins a priority competition does not mean that all value from the asset at issue will necessarily be given to that creditor alone. Each asset would be dealt with in this way.” See Darcy L. MacPherson, “Financial Leasing in Common Law Canada,” (2011) 16:1-2 *Unif Law Rev* 83.

¹⁰ See, for example, Cuming, Walsh and Wood, *supra* note 3, at 7. As to certainty, see, for example, *Sun Life Assurance Co of Canada v Royal Bank* (1995), 10 PPSAC (2d) 246 at 251-252, 129 DLR (4th) 305 (Ont Gen Div) Winkler J, as he then was, and *Strathcona Brewing Co v Eldee Investment Corp* (1994), 17 Alta LR (3d) 405, 6 PPSAC (2d) 177 (Alta QB), Agrios J [*Strathcona*].

¹¹ See the PPSA, *supra* note 1, s 65(3).

¹² See the PPSA, *ibid*, s 65(4).

¹³ See the PPSA, *ibid*, s 65(2).

What, then, is sufficient to trigger the second and fourth principles referred to above? First, it is clear that something more than mere knowledge on the part of Creditor #2 of the pre-existing, but unperfected, security interest held by Creditor #1 is required in order to place Creditor #2 behind Creditor #1. In essence, that “something more” must be comprised of either one or both of the following, as far as the Court is concerned:

- a) inequitable conduct on the part of Creditor #2; and
- b) bad faith on the part of Creditor #2.

The application of these rules is illustrated in the cases referred to in the next section.

IV. THE CASE LAW

The four cases below will assist in illuminating these principles. These cases are dealt with in chronological order. In Part V, the authors will lay out the conclusions that they believe can be drawn from the totality of the cases.

A. *Carson Restaurants International Ltd v A-1 United Restaurant Supply Ltd*¹⁴

In this case, the relationships between the various players are especially important. Therefore, our analysis begins with these relationships. The debtor is Yorkton Restaurant and Deli Ltd. (Yorkton).¹⁵ Yorkton was controlled by a Mr. Dennis A. Skuter (Skuter).¹⁶ Yorkton entered into a franchise agreement between Yorkton, as franchisee, and Carson Restaurants International Ltd. (Carson), as franchisor.¹⁷ Skuter is the sole officer, director and shareholder of Carson.¹⁸ In other words, the agreement was between associated corporations. Shonavan Holdings Inc., (Shonavan) was a third company controlled by Skuter.¹⁹ The final person involved in this scenario is A-1 United Restaurant Supply Ltd (A-1). A-1 is unrelated to Skuter.²⁰

The transactions that are immediately relevant to the resolution of the issues between the parties are as follows. In September 1986, Carson acquired a security interest in Yorkton’s present and after acquired personal property (as a result of the franchise agreement between them).²¹ In April 1987, A-1 acquired a security

¹⁴ [1989] 1 WWR 266, 8 PPSAC 276 (Sask QB), Grotsky J [Carson].

¹⁵ *Ibid* at 269.

¹⁶ *Ibid*.

¹⁷ *Ibid*.

¹⁸ *Ibid*.

¹⁹ *Ibid* at 270.

²⁰ *Ibid*.

²¹ *Ibid* at 269.

interest from Yorkton covering goods provided by A-1 to Yorkton on credit.²² By June 1987, Yorkton was in default on payment of its obligations owed to A-1.²³ A-1 demanded payment. Following that demand, there was a meeting between representatives of A-1 and Skuter. Mr. Skuter assured A-1's representative that Yorkton would pay its debt to A-1.²⁴

In July 1987, A-1 registered its security interest but made a serious error in recording Yorkton's name in its registered financing statement.²⁵ On 1 October 1987, Shonavan, in anticipation of selling certain equipment to Yorkton on credit and taking a security interest therein, obtained a PPR search of Yorkton's correct name, which did not reveal A-1's security interest which had been registered against Yorkton's incorrect name.²⁶ On 26 October 1987, Carson registered its security interest against Yorkton Restaurant's correct name, and, on the same day, Shonavan also registered its security interest against Yorkton's correct name.²⁷ The following month, Skuter registered his own security interest against Yorkton's correct name. On 20 January 1988, Yorkton Restaurant was in default with respect to its obligations owed to Carson. Therefore, Carson seized all of Yorkton's assets. Finally, on 26 January 1988, A-1 amended its financing statement to show the correct name of Yorkton. In the nomenclature referred to earlier, A-1 is Creditor #1, Yorkton is the debtor, and Skuter and the other corporations controlled by him are Creditor #2.

Therefore, the priority competition arises between A-1, on the one hand, and Skuter and the other corporations controlled by him (the "Skuter Group"), on the other. The Court held that between A-1 and the Skuter Group, A-1 should prevail. The Court begins by citing the speech of Lord Westbury in *McCormick v Grogan*, holding as follows:

The Court of Equity has, from a very early period, decided that even an Act of Parliament shall not be used as an instrument of fraud; and if in the machinery of perpetrating a fraud an Act of Parliament intervenes, the Court of Equity, it is true, does not set aside the Act

²² *Ibid* at 270.

²³ *Ibid*.

²⁴ *Ibid*.

²⁵ *Ibid*.

²⁶ *Ibid*. With respect to serious misleading errors, see PPSA, *supra* note 1, s 43(6). The weight of authority indicates that if (i) a person enters incorrect information in a financing statement, and (ii) a search of the correct information would not show the relevant registration as a close or exact match, then it is "seriously misleading". See *Gold Key Pontiac Buick (1984) Ltd v 464750 BC Ltd (Trustee of)* (2000), 2000 BCCA 435, 189 DLR (4th) 668; *GMAC Leaseco Ltd v Moncton Motor Home & Sales Inc. (Trustee of)*; *Stevenson v GMAC Leaseco Ltd* (2003), 2003 NBCA 26, 227 DLR (4th) 154; *Coates v General Motors Acceptance Corp. of Canada*, [1999] 10 CBR (4th) 116, 14 PPSAC (2d) 315 (BCSC) Grist J. Despite the weight of this authority, there are some cases that indicate that a computer system's programming should not determine the validity of the registration. On this point, see *Re Logan* (1992) 15 CBR (3d) 121, [1993] 2 WWR 82 (BCSC) Tysoe J (as he then was).

²⁷ *Carson, ibid*.

of Parliament, but it fastens on the individual who gets a title under that Act, and imposes upon him a personal obligation, because he applies the Act as an instrument for accomplishing a fraud. In this way the Court of Equity has dealt with the Statute of Frauds, and in this manner, also, it deals with the Statute of Wills.²⁸

The Court noted that fraud was not alleged against any member of the Skuter Group.²⁹ Nevertheless, the Court held that:

...To permit Carson to take advantage of A-1 in the circumstances outlined would be to permit it, through Skuter, to use the Act as an instrument to defeat a claim of which he was not only aware, but which he deceitfully delayed by his representations to A-1 when it was pursuing its security interest against Yorkton Restaurant & Deli Ltd. on or about 18th June 1987.³⁰

Accordingly, the priorities which would otherwise result from a strict application of the legislation should not be applied on the facts of this case, and should be overturned by the application of equitable principles.

One of the interesting elements of this case is that the facts as spelled out in Justice Grotsky's decision do not, in and of themselves, explicitly indicate that Mr. Skuter made deceitful representations to A-1 at the time of the 18 June 1987 meeting. However, the emphasized words indicate that such deceitful representations were in fact made and that they were made by Mr. Skuter with the objective of inducing A-1 to not take the steps necessary to achieve PPSA priority for A-1's security interest.

***B. Canadian Imperial Bank of Commerce v AK Construction (1998) Ltd*³¹**

In this case, CIBC and RoyNat both loaned money to two debtor corporations related to each other (collectively, the "Debtor") for the purpose of enabling the Debtor to acquire certain heavy construction equipment.³² The equipment was "serial numbered goods"³³ under the PPSA and its Regulations,³⁴

²⁸ (1869-70) LR 4 HL 82 at 97.

²⁹ Carson, *supra* note 14 at 276.

³⁰ *Ibid* [emphasis added].

³¹ (1995), 9 PPSAC (2d) 257, [1995] 8 WWR 120 (Alta QB), Veit J [CIBC]. This case was appealed to the Court of Appeal on an issue not relevant to the discussion. The appeal was dismissed. See *Canadian Imperial Bank of Commerce v AK Construction (1988) Ltd* (1998), 223 AR 115 (CA).

³² CIBC, *ibid* at para 1.

³³ "Serial numbered goods" is a term used throughout the PPSA, *supra* note 1. On this point, see ss 30(6), 35(4), 38(12), 43(7), 48(1), 59(6), 60(2), 61(2) and 72. However, the PPSA itself does not define the term. Instead, this is left to the regulations promulgated under the authority of the PPSA. On this point, see s 73(g)(iii) of the PPSA. The relevant regulation is the *Personal Property Registry Regulation*, Man Reg 80/2000 [the "Regulation"]. The Regulation provides (in s 1): "serial numbered goods" means (a) except where clause (b) applies, motor vehicles, trailers, mobile homes, aircraft, boats or outboard motors for boats, and (b) in relation to a registration that was made before the Act came into force, collateral referred to in clause (a) that, under the

but only CIBC properly registered its security interest against the serial numbers, RoyNat omitting to register against the serial numbers.³⁵ RoyNat had registered first (without serial numbers), and CIBC registered second (with serial numbers). In the nomenclature referred to earlier, RoyNat is Creditor #1, and CIBC is Creditor #2.

The Debtor became insolvent, the equipment was sold and a contest arose between CIBC and RoyNat as to who was entitled to the proceeds of sale of the serial numbered equipment. Absent considerations of knowledge, fraud and bad faith, the parties agreed that CIBC would be first in line, due to its registration of the serial numbers.³⁶

CIBC argued that it had done what it was supposed to do under the legislation and RoyNat had failed to do what it was supposed to do, with the result that CIBC should be entitled to the proceeds of sale, not RoyNat.³⁷ RoyNat argued that there was an underlying understanding between CIBC and RoyNat to the effect that RoyNat was to have a first charge on the Debtor's equipment and CIBC was to have a first charge on the Debtor's accounts receivable and inventory. There was at least one meeting between representatives of CIBC and RoyNat at which they discussed their respective security positions.³⁸ As the Court put it:

In summary, "bad faith" for the purposes of the PPSA requires some form of positive action on the part of the party with the prior perfected security interest. Mere knowledge of the prior unperfected security interest that will be defeated by the registration is not sufficient. The required action is action that could constitute a waiver or support an estoppel argument or actively mislead or hinder the perfection of the prior interest.³⁹

In other words, CIBC had the following knowledge with respect to its relationship with RoyNat, and their respective impacts on each other:

- a) of the existence of RoyNat's security interest; and

law in force immediately before the Act came into force, was, or was required to be, described in the area of the financing statement designated for motor vehicle description". Many of the terms used in this definition (such as "aircraft", "boat", and "motor vehicle") are also defined in s 1 of the Regulation. For current purposes, though, it is generally true to say that high-value, fungible, and highly mobile goods (such as cars, trucks and mobile equipment) are generally serial numbered goods for the purposes of the PPSA. In some cases, including on the facts of *CIBC*, the result of a priority competition may be affected by whether or not the secured party creditor has registered against the serial number in question.

³⁴ See the Regulation, *ibid*.

³⁵ *CIBC*, *supra* note 31, at para 20.

³⁶ *Ibid* at paras 21-22.

³⁷ *Ibid* at paras 27-29.

³⁸ *Ibid* at paras 23-24.

³⁹ *Ibid* at para 38.

- b) if RoyNat had properly registered its security interest, it would have held priority over CIBC's security interest, but RoyNat's security interest had not been properly registered.⁴⁰

However, this was not sufficient to constitute "bad faith". The Court impliedly held that CIBC did not undertake to subordinate its security interest in favour of RoyNat (or treat RoyNat's security interest as holding priority over CIBC's security interest) so as to bar itself from relying on its (CIBC's) rights under the legislation. The Court did so in following terms:

As to the impact of the Readman affidavit, silence can sometimes be equivalent to agreement, but this is not one of those times. This was a meeting of persons who all had an interest in the A.K. companies but who were, in some senses, competitors with respect to the A.K. assets. One could not expect competitors to be fully open with one another in relation to their various positions. When Readman told the meeting what he thought of the security situation, this could be taken as a negotiating posture as much as anything else.⁴¹

For CIBC to have been subordinated to RoyNat, RoyNat would have had to have established something which would constitute a waiver or an estoppel argument, or would involve CIBC in some nefarious conduct, such as misleading RoyNat or hindering it in the perfection of its security interest.⁴² No behaviour of this type could be attributed to CIBC on the facts of this case. Therefore, CIBC maintained priority.

C. *Strathcona Brewing Co v Eldee Investment Corp*⁴³

In this case, the question was whether a creditor, Eldee, was entitled to amend its pleadings against two brewing companies. Another creditor, the Chappells, were opposed. Eldee had a registered security interest in property of the debtor.⁴⁴ Berman was the solicitor for Eldee.⁴⁵ Berman was the intermediary for the funds from Eldee to the brewing companies. The Chappells were subsequently asked to advance funds to the debtor.⁴⁶ The Chappells agreed with the debtor to do so, with the proviso that the security interest registered by Eldee be discharged.⁴⁷ Therefore, it is clear that the Chappells did not want their security interest in property of the debtor to rank behind that of Eldee. Once again, Berman was used as the intermediary. The Eldee security interest was

⁴⁰ *Ibid* at para 40.

⁴¹ *Ibid* at para 41.

⁴² *Ibid* at para 38.

⁴³ *Strathcona*, *supra* note 10.

⁴⁴ *Ibid* at para 4.

⁴⁵ *Ibid*.

⁴⁶ *Ibid*.

⁴⁷ *Ibid*.

discharged,⁴⁸ allegedly by Berman, and without the consent of Eldee.⁴⁹ Technically, the Chappell security interest was registered following the discharge of the Eldee security interest. Eldee wanted the Court to treat the Eldee security interest as not having been discharged, and therefore, as effective and relevant to the priority competition. The Court declined to do so, for the following reasons:

- a) This would undermine certainty;⁵⁰
- b) To import actual notice into the PPSA would actually run counter to express provisions of the PPSA;⁵¹
- c) There is nothing beyond mere knowledge to suggest bad faith on the part of the Chappells;⁵²
- d) Eldee had a chance, pursuant to the provisions of the PPSA,⁵³ to remedy the discharge, within a given period of time. Having not done so, it was not entitled to a remedy from the Court.⁵⁴

Therefore, the Court relied on the first and third principles referred to earlier to hold in favour of the Chappells. Furthermore, Justice Agrios essentially held that the application of the principles of equity would actually run counter to the PPSA, rather than supplementing its provisions.⁵⁵

D. *Furmanek v Community Futures Development Corp of Howe Sound*⁵⁶

In this case, the vendor of shares in a business, the plaintiff, Furmanek, gave the purchaser time to pay for the shares purchased. Therefore, a security interest in the purchaser's assets was granted to Furmanek, who then made a proper registration of this security interest⁵⁷ in the Personal Property Registry.⁵⁸ In addition to the security interest given to the vendor, the purchaser borrowed part of the purchase price from Community Futures Development Corporation of Howe Sound ("Development"). A security interest was granted to Development, which also registered its security interest⁵⁹ in the Personal Property Registry.⁶⁰ In

⁴⁸ To "discharge" a security interest means to remove the financing statement from the Registry. Typically, this is done when the debtor's obligation to the creditor is extinguished, or otherwise forgiven.

⁴⁹ *Strathcona*, *supra* note 10, at para 5.

⁵⁰ *Ibid* at para 11.

⁵¹ *Ibid* at para 12.

⁵² *Ibid* at para 13.

⁵³ See the PPSA, *supra* note 1, s 35(7).

⁵⁴ *Strathcona*, *supra* note 10, at para 14.

⁵⁵ *Ibid* at para 13.

⁵⁶ (1998) 162 DLR (4th) 501, [1998] BCJ No 1536 (BCCA) [*Furmanek*].

⁵⁷ *Ibid* at para 2, citing the chambers judge. All paragraph references are *per* DLR.

⁵⁸ *Ibid*.

⁵⁹ *Ibid*.

⁶⁰ PPSA, *supra* note 1, s 42.

fact, Development registered prior to the plaintiff Furmanek,⁶¹ but in so registering, Development erroneously omitted to refer to the purchaser's inventory in its financing statement.⁶² When the purchaser failed to pay what it owed, a priority contest arose between the vendor and Development as to the purchaser's inventory. In other words, in this scenario, in accordance with the nomenclature used previously, Development was Creditor #1, Furmanek was Creditor #2, and the purchaser was the debtor.

Furmanek (for obvious reasons) argued that the PPSA required that a secured party strictly comply with the applicable registration rules, failing which it should not be considered to have perfected its security interest, or, in other words, it should not be entitled to priority as against Furmanek's proper registration.⁶³ The Court noted the following facts:⁶⁴

- a) Furmanek knew that without Development's financing, the sale and purchase transaction would not have been completed;
- b) Furmanek was actively involved in the negotiations between the purchaser and Development leading to the provision of the Development financing, and represented to Development that the assets being acquired by the purchaser from Furmanek were "free and clear" and that accordingly, Development expected to obtain a first charge on the inventory;
- c) Furmanek knew that if Development did not obtain a first position on the purchaser's inventory, Development would not provide financing; and
- d) in the sale and purchase agreement between Furmanek and the purchaser, the security interest granted by the purchaser back to Furmanek for part of the purchase and sale price was referred to as a "second mortgage".⁶⁵

The Court of Appeal held in favour of Development. On the facts, in the view of the authors, justice was done, as it would have been manifestly unfair to allow the vendor to take advantage of Development's registration omission. However, it is exceptionally important to note that the Court based its decision on more than just what seemed fair or unfair. In particular, the Court held that:

- a) generally speaking, registration of a security interest with knowledge of a prior unregistered security interest will not of itself constitute bad faith or operate as an estoppel against the registering party⁶⁶ (affirming the third principle referred to above);

⁶¹ *Supra* note 56, at para 2, citing the chambers judge.

⁶² *Ibid.*

⁶³ *Ibid* para 6.

⁶⁴ *Ibid* para 12, citing the chambers judge.

⁶⁵ *Ibid* at para 15.

⁶⁶ *Ibid* at para 12, citing the chambers judge.

- b) however, the circumstances in the case went “beyond mere knowledge of the fact that [Development] was asserting a prior interest”⁶⁷ (meaning that the third principle did not apply);
- c) although the vendor did not expressly agree to subordinate its security interest in favour of Development’s security, the PPSA makes it clear that a secured party may subordinate its interest in ways other than inclusion of a subordination provision in a security agreement.⁶⁸ The statute provides that “Any secured party may, in a security agreement or otherwise, subordinate his or her security interest to any other interest...”⁶⁹;
- d) the Court of Appeal also held that Development could have priority over the vendor on the basis of an implied agreement or undertaking by the vendor to subordinate its security position to that of Development. In this regard, remember the above-noted factual holding that in the purchase and sale agreement, the vendor referred to its security interest as a “second mortgage”;⁷⁰
- e) On these facts, PPSA priorities may be determined by the application of equitable principles⁷¹ (affirming the fourth principle referred to above);
- f) On the basis of equity, the Court imposes an obligation on the individual who is seeking to take what the Court believes to be an inequitable advantage against one or more others on the basis of the strict operation/application of the legislation, without invalidating the legislation in any way;⁷²
- g) The Court held that on the basis of the vendor’s unfair conduct, the vendor’s security interest in the purchaser’s inventory was equitably subordinated to Development’s interest.⁷³ It is implicit in the reasoning of the Court that if the vendor had not known of the prior security interest of Development (or had not induced Development to believe that Development would get a first priority position), the equities would not have favoured Development; and
- h) While the vendor’s knowledge and unfair conduct protected Development as against a claim by the vendor, the same would not have been true if an innocent third party was involved.⁷⁴ Thus, if the vendor had sold its debt claim and security interest to a *bona fide* assignee, that

⁶⁷ *Ibid* citing the trial judge.

⁶⁸ *Ibid* at para 19.

⁶⁹ PPSA, *supra* note 1, s 40(1). The British Columbia equivalent is found in the *Personal Property Security Act*, RSBC 1996, c 359, s 40.

⁷⁰ *Supra* note 56, at para 15.

⁷¹ *Ibid* at para 21.

⁷² *Ibid*.

⁷³ *Ibid*.

⁷⁴ *Ibid* at para 19.

assignee would almost certainly be entitled to hold priority over Development.

V. LESSONS FOR THE BENCH AND BAR

In the view of the authors, this case law offers several valuable lessons, both for the Manitoba courts that will eventually have to confront this issue, and for practitioners, for both the litigators who will be in courts dealing with these arguments, and for the solicitors who are asked to advise clients who find themselves in these types of circumstances.

A. What are the key elements to distinguish *Carson* from *CIBC*?

In many senses, *Carson*⁷⁵ and *CIBC*⁷⁶ are quite similar. Both cases involve not only knowledge by Creditor #2 of the pre-existing security interest of Creditor #1, but also involve specific representations of Creditor #2 to Creditor #1 as the relative priority of the security interests of the two creditors. Despite these important similarities, the courts came to diametrically opposed results. In the view of the authors, these different results are in fact reconcilable.

First, in *CIBC*, it was quite clear that the debtor was already experiencing financial difficulties, at the time that the meeting at which the representations of Creditor #2 were made. This would inevitably put any two creditors in a situation of jockeying for position, where an event of default⁷⁷ has either occurred, or is very likely to occur in the near future. Equity generally seeks to protect those who cannot protect themselves, rather than protecting those who could have protected themselves but chose not to do so.⁷⁸ Clearly, in *CIBC*, the Court was of the view that all RoyNat had to do was register its interest. In fact, the PPSA is specifically set up as a notice system. This means that a creditor need not only give notice to *CIBC* of its position, but also to all interested parties. Therefore, RoyNat could

⁷⁵ *Supra* note 14.

⁷⁶ *Supra* note 31.

⁷⁷ Events of default are typically defined by the agreement between the debtor and the creditor. These are typically events the occurrence of which entitles the creditor to realize on the security provided for in the agreement. To “realize on the security” is generally to seize the collateral, and sell it in attempt to recover amount owing to the creditors of the debtor.

⁷⁸ On this point, see, for example, *International Corona Resources Ltd v Lac Minerals Ltd*, [1989] 2 SCR 574 at p 607, 61 DLR (4th) 14, Sopinka J, dissenting in the result, but not on this point; McIntyre J concurring, citing *Hospital Products Ltd v United States Surgical Corp* (1984), 55 ALR 417, 156 CLR 41 (HCA); *Weinberger v Kendrick* (1892) 34 Fed Rules Serv (2d) 450 (NY Ct App); *Barnes v Addy* (1874) 9 Ch App 244 at 251, Lord Selborne, Lord Chancellor; *Guerin v The Queen*, [1984] 2 SCR 335 at 384, [1984] 6 WWR 481, and Ernest J Winrib, “The Fiduciary Obligation” (1975) 25 UTLJ 1. While some of the comments referred to in these sources are in the context of the fiduciary obligation, in the view of the authors, the basic point made herein also applies more generally to the use of equitable principles.

have (and implicitly, should have) protected itself. Competitors generally do not rely on the ambiguous assertion of their fellow competitors to protect their interests. Where it is clear that where the relationship is one of competitors, the Court is less likely to imply a need for one creditor to protect the economic interests of the other.

This presumption is all the more powerful when the representation is, as referred to earlier, ambiguous. In *CIBC*, the Court viewed the words that were alleged to lead to a finding of fraud were actually just a statement of the current situation, as it existed at the time that the words were spoken. This statement was not meant to guarantee a state of affairs in the future as between the creditors. As the Court put it, it is simply a statement of what everyone already knew.⁷⁹ Stating a fact does not make a fraud

On this level, *Carson* is quite different. In this case, Skuter represented both Creditor #2 and the debtor. When Creditor #1 indicates the intention to realize on its security, and Skuter requests an extension, this is not a competitive situation. Both the debtor and Creditor #1 are hoping that, despite the event of default that has occurred, if the debtor is given more time, the creditor will be paid out in full, and any realization of security will become unnecessary. In other words, there is a form of co-operation at hand, through an indulgence granted by the creditor to the debtor. The law should seek to encourage such indulgences, as realization on security through the default of the debtor should be a last resort, as between creditor and debtor.⁸⁰ But, instead of viewing the indulgence granted by the creditor as a co-operative reprieve, the person who controlled the debtor (Skuter) used the indulgence as a means to pursue actions that would ultimately lead to a possibility that the creditor would lose a priority competition to the person who possibly asked for, and certainly accepted, the advantage of the indulgence and the co-operative basis on it was offered.

Carson is quite clear that deceit is unacceptable. Behaviour that is unjust may not be enough for the Court to use equitable principles to avoid the effect of PPSA's priority provisions, but it is also evident that if the Court finds actual or constructive⁸¹ fraud, it will not allow the PPSA's provisions to facilitate the success

⁷⁹ *CIBC*, *supra* note 31, at para 40.

⁸⁰ This is also consistent with the general law of contracts. On this point, see the judgment of Justice Ritchie, writing for the Court in *John Burrows Ltd v Subsurface Surveys Ltd*, [1968] SCR 607, 68 DLR (2d) 354. In this case, the debtor tried to use an indulgence granted by the creditor as the basis for a promissory estoppel, saying that the indulgences was a representation as to future action. The Supreme Court of Canada disagreed, holding that the indulgence did not constitute a representation that could be relied upon by the debtor.

⁸¹ One sees an example of constructive fraud in *Carson* itself. The court does not find actual fraud. In fact, Justice Grotzky finds that it is not even alleged against Skuter on the facts. See *Carson*, *supra* note 14, at para 18. Nonetheless, the Court refuses to allow the priority rules of the PPSA to be applied, based on not allowing an act of the legislature was be the machinery of fraud (at para 17).

of such a scheme. In other words, the litigator for Creditor #1 must convince the Court that something that Creditor #2 did departs from the expected behaviour of a creditor who is taking the best security that he or she can for the loan. If Creditor #2 makes it less than clear that Creditor #2 is being unequivocally self-interested and appears to be assisting Creditor #1 to achieve a result desired by Creditor #1, the court may not allow Creditor #2 to assert priority.

B. The Subordination Agreement

A similar rationale also holds for the *Furmanek*⁸² decision. In that case, Creditor #2 was actually involved in the negotiations with Creditor #1:

1. The vendor [Furmanek] was actively involved in negotiations between the purchaser and the lender [Community Futures Development] for financing the purchase of his business by the employee.
2. The vendor knew that without Community Futures financing the transaction, the transaction would not complete.
3. The vendor received monies at closing and benefitted from the transaction completing and therefore benefitted from the lender's advance.
4. The vendor represented to the lender that the assets were free and clear in the expectation that the lender would take a first charge on the inventory if the transaction completed and the vend[or] represented that he would take a subsequent charge.
5. The vendor knew that if the lender was not in first position on the assets, it would not finance the transaction and the sale to the employee would not complete.
6. Therefore, the lender assumed that it was in first position on the inventory; that assumption was in accordance with the discussions it had had with the vendor; the lender financed the transaction on that assumption, which it expected to happen; the vend[or] has benefitted from the lender's financing of the transaction; the lender will suffer detriment if it is not in a first position on the inventory; and that will be the situation if the vendor asserts the priority that he is entitled to by way of registration.⁸³

As the Court found, Creditor #2 encouraged the assumption of priority over inventory by Creditor #1, and then took advantage of that assumption, with the explicit representation of priority as an inducement to invest. This in itself would be enough to find bad faith. However, there is an additional element at play here. The promise of *Furmanek* is to ensure that the assets will be free of any other security interest, and that Development will rank in priority to *Furmanek*. In return for this promise, Development agreed to lend money to the purchaser to complete the purchase. This meets the basic criteria for a contract. Therefore, the Court finds that there was an unequivocal intention to forego priority for *Furmanek*, in favour of Development.

Therefore, where a litigator is preparing an argument: (i) on behalf of an improperly registered creditor; (ii) where the improperly registered creditor has significant contact with another creditor; (iii) where, according to the provisions

⁸² *Supra* note 56.

⁸³ *Ibid* at para 12.

of the PPSA, the second creditor should prevail over the first; then (iv) it may be possible to argue that a written or oral subordination agreement⁸⁴ was entered into, and (v) if the agreement exists and the court recognizes that it exists, then, as between the parties to it, the priority of the parties is determined by their agreement.

C. “It Wasn’t Me, My Lawyer Did It” Is No Defence

In *Strathcona*,⁸⁵ there is a message for solicitors. When one is asked to discharge a security interest, one can only take instructions from the secured party named in the financing statement to be discharged. Remember that in *Strathcona*, the Court found that Creditor #1 could not rely on the fact that the discharge completed by the solicitor was not authorized by the client as a reason to disallow reliance of Creditor #2 on the provisions of the PPSA. Put another way, the relationship between solicitor and client will not generally result in a finding of fraud against a third party. This is true even if the same solicitor acts for Creditor #2 in a separate transaction. Nonetheless, it is the view of the authors that if there is collusion between the solicitor and Creditor #2 to bring about a result favourable to Creditor #2, the courts will not allow this, viewing it as constructive fraud.

However, there is still every reason for solicitors to lay out (usually in writing) whose instructions will govern in a given situation, where there are multiple parties involved. A prudent solicitor might also want to get discharge instructions in writing, either before or after providing to the client written confirmation of the steps necessary to remedy an unintended discharge. After all, undoubtedly, Berman would have been the next logical target for Eldee for the value lost due to the discharge, which, from Eldee’s point of view, was unintended.

VI. CONCLUSION

Above, we have discussed two cases where the PPSA’s registration priority provisions have been upheld despite allegations that the knowledge of the one creditor should not allow the creditor to reap an unintended advantage, benefit, or windfall due to the mistake of another creditor. We have also seen two cases where the converse was true. From the point of view of the authors, the four cases can stand together as a cohesive whole. As a general rule, the priority provisions of

⁸⁴ A subordination agreement is a contract (or a part of a contract) where one creditor agrees to forego the priority that would otherwise accrue to his interest over the interest of another creditor. In other words, a subordination agreement is an arrangement by which creditors can agree as between themselves as to their respective priorities in the common collateral. The priorities agreed upon may be different from the priorities that would otherwise be established by the rules of security registration or possession provided for in the PPSA.

⁸⁵ *Supra* note 10.

the PPSA will govern, meaning that one creditor is allowed to take advantage of the mistake of another. However, where there is more than mere knowledge of a pre-existing security interest, and one secured creditor has been led, by the other, “down the garden path”, through fraud or something akin to it, the statutory priority scheme will be ignored, so as to defeat the fraudulent intent of the misleading creditor. The more involved the misleading creditor is with the other, in causing the other person to become a creditor, the more likely it is that the courts will find the misleading creditor to be acting in bad faith, which will not be allowed.