COMMENTARY

Dueling Purchase-Money Security Interests Under the PPSA: Explaining the Law and Policy Behind Section 34(7)

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I. INTRODUCTION

As a full-time law school academic who teaches the law of secured transactions, I am often asked for explanations of the rationales behind lesser-used sections of the *Personal Property Security Act*.[1] While I am happy to help those who seek my assistance on a one-on-one basis, I have also decided to provide some of these explanations in writing in order to provide a resource for those who are looking for a more tangible place to turn. This article is set out as a series of questions and answers and assumes that the reader knows little or nothing with respect to the basic concepts of the PPSA. It is intended not as an innovative treatise but rather, as a useful explanatory tool for those either utilizing or interested in the PPSA.

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1 SM 1993, c 14, CCSM c P35 [PPSA].

Subsection 34(7) of the PPSA reads as follows:

> 34(7) A non-proceeds purchase money security interest has priority over a purchase money security interest in the same collateral or proceeds, if the non-proceeds purchase money security interest is perfected
> (a) in the case of inventory, at the date a debtor, or another person at the request of a debtor, obtains possession of the collateral, whichever is earlier; and
> (b) in the case of collateral other than inventory, not later than 15 days after a debtor, or another person at the request of a debtor, obtains possession of the collateral, whichever is earlier. [2]

II. WHAT IS A SECURITY INTEREST?

While not a comprehensive definition,[3] for the purposes of this discussion, a security interest exists where the holder of property (the "debtor") wishes to borrow money from another person (the "creditor"), and in order to ensure repayment of the loan, the debtor gives the creditor the right to seize personal property of the debtor if the loan is not repaid on time. The interest in the debtor's property given by the debtor to the creditor is a "security interest".

III. WHAT IS A PURCHASE MONEY SECURITY INTEREST?

A purchase money security interest also known as a "PMSI" is defined by the Act as follows:

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[2] *Ibid*, s 34(7).

[3] A full definition can be found in the PPSA, *ibid*, s 1, *sv* "security interest". There are certain types of transactions that are not designed to secure the performance of an obligation that are nonetheless deemed by the PPSA to be "security interests". These include true leases of more than one year, commercial consignments, and the transfer of an account or chattel paper. However, there are two reasons that this paper will not deal with these deemed security interests. First, to explain why the PPSA deems these agreements to involve security interests is beyond the scope of this paper.
Second, two types of these deemed security interests are PMSIs. See PPSA, s 1, *sv* "purchase money security interest". The definition of this term is reproduced below. Particular attention should be paid to paragraphs (c) and (d) which deal specifically with these deemed interests. However, it would be reasonably rare that this would arise in this context, although the possibility does exist. The fact that the security interest is one of the "deemed" security interests would not alter the substance of the analysis offered below. Therefore, further specific analysis of these "deemed" security interests will not be offered here. That will have to wait for another day.

> "purchase money security interest" means
> (a) a security interest taken or reserved in collateral, other than investment property, to the extent that it secures all or part of its purchase price,
> (b) a security interest taken or reserved in collateral, other than investment property, by a person who gives value for the purpose of enabling the debtor to acquire rights in the collateral, to the extent that the value is applied to acquire the rights,
> (c) the interest of a lessor of goods under a lease for a term of more than one year, and
> (d) the interest of a consignor who delivers goods to a consignee under a commercial consignment,
> but does not include a transaction of sale and the lease back to the seller; and for the purpose of this definition, "purchase price" and "value" include credit charges or interest payable in respect of the purchase or a loan given to enable the debtor to acquire rights in the collateral; [4]

Therefore, in simple terms, a purchase-money security interest is where either of the following two things happens. One, the lender is told that the loan is to be used to acquire certain property, the money is used to acquire that property, and the security interest is granted in that property by the debtor. Two, the vendor of the property gives the debtor time to pay for the property purchased, and is granted a security interest in the property to ensure payment. The former situation is "lender" credit; the latter is "vendor" credit. In either case, the creditor receives a PMSI.

IV. WHY DO WE NEED THE CONCEPT?

The existence of the PMSI concept is derived from a combination of three factors. First, the PPSA allows a secured party to take a security interest in personal property that the debtor does not yet own.[5] While the security interest will not attach to the property until the debtor has rights in that property,[6] it can attach as soon as it is agreed that the property is to be given to or used by the debtor. Attachment is the creation of a security interest in a particular piece of personal property.[7] The personal property in which a security interest is taken is called "collateral".[8]

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4 PPSA, *ibid*, s 1 *sv* "purchase money security interest".

5 This is typically referred to as an "all present and after-acquired property" security interest. See PPSA, *supra* note 1, s 10(1)(d)(iii).

6 *Ibid*, s 12(1)(b).

7 See e.g. Ronald CC Cuming, Catherine Walsh, & Roderick J Wood, *The Essentials of Canadian Law – Personal Property Security Law*, 2d ed (Toronto: Irwin Law, 2012) at 246-

Second, because the secured party has already properly registered a financing statement[9] against all property of the debtor, the security interest is "perfected". Perfection, in this context, is the state in which the secured party has done everything necessary (as between the secured party and the debtor) to achieve the best possible position of the security interest as against other claimants to the property. To be perfected, a security interest must be attached[10] and a perfecting step must be taken. Under the PPSA, two possible perfecting steps exist: (i) registration of a financing statement in the public registry (also called the "Personal Property Registry" or "PPR"),[11] or (ii) possession of tangible collateral[12] by the secured party.[13] For these purposes, we will focus on the former of these perfecting steps.

Third, as between two security interests, both of which are perfected, the first secured party to take a perfecting step will generally have priority[14] over a security interest where the perfecting step is taken later.[15]

266 [Cuming, Walsh & Wood].

8 PPSA, *supra* note 1, s 1, *sv* "collateral".

9 A financing statement is the document filed in the public registry to show that a security interest has been taken in one or more pieces of personal property.

10 Cuming, Walsh & Wood *supra* note 7, at 240-246.

11 PPSA, *supra* note 1, s 25.

12 Most collateral is tangible, or has some tangible manifestation that can be possessed for the purposes of the PPSA. However, some types of collateral (such as an account, including an account receivable by the debtor) do not. For obvious reasons, these types of collateral cannot be possessed in the traditional sense.

13 PPSA, *supra* note 1, s 24.

14 Priority is the ranking of interests in the collateral if there is a conflict between the various interests in the collateral. It is best analogized to a line. The PPSA does not limit the number of security interests that can be granted in any piece of collateral. Instead, the PPSA is concerned with prioritizing any number of interests in the collateral. Sometimes, these interests are security interests as referred in the PPSA. Other times, it is the interests of a trustee in bankruptcy (*ibid*, s 20(b)), other creditors who do not have a security interest in the collateral and others involved in assisting the creditor in recovering the debt owed (*ibid* s 20(a)), and sometimes still others such as purchasers and lessees of the collateral (*ibid*, s 20(c) and ss 30-31). Nonetheless, there can be other statutes which create the equivalent of security interests, which may not be covered by the PPSA. For example, statutorily mandated builders' and repairers liens are not addressed by the PPSA. Statutory liens in favour of government are generally not covered. *Ibid*, s 4(a). Also, transactions that are in substance federally-created security interests are not covered including those under the *Bank Act*, SC 1991, c 46, and the *Canada Shipping Act, 2001*, SC 2001, c 26. See PPSA, *supra* note, s 4(k).

The combination of these factors means that without the concept of a PMSI, the first secured creditor who was granted an all present and after-acquired property security interest would defeat every subsequent secured creditor, even if the credit granted by the subsequent secured creditor was required for the debtor to survive or expand.

But many creditors are far less likely to extend credit where there are no assets of the debtor with respect to which the new creditor will rank in priority to all the other creditors.[16] In other words, without the concept of a PMSI, at least some types of potential creditors will be less likely to extend credit. These factors, therefore, may actually reduce the sources of credit when there is an "all present and after-acquired property" security interest given by the debtor.

The concept of a PMSI allows for a special priority rule.[17] More specifically, subsection 34(2) provides as follows:

> 34(2) Subject to subsection (6) and section 28, a purchase money security interest in
> (a) collateral or its proceeds, other than intangibles or inventory, that is perfected not later than 15 days after the day the debtor, or another person at the request of the debtor, obtains possession of the collateral, whichever is earlier; or
> (b) an intangible or its proceeds that is perfected not later than 15 days after the day the security interest in the intangible attaches;
> has priority over any other security interest in the same collateral given by the same debtor.[18]

In other words, the fact that something is a PMSI means that, provided certain procedural requirements are met,[19] the holder of that

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15 PPSA, *supra* note 1, s 35(1)(a).

16 It is true that some creditors neither demand, nor expect, security as part of their credit arrangements. One example of such a creditor is certain types of trade creditor. Imagine a restaurant business that gets meat from a local butcher. The butcher gives the restaurant time to pay for the meat (say 30 days). During the 30 days, credit is being extended; the restaurant is the debtor, and the butcher is the creditor. With this type of credit, it would be unusual for the credit to be given on a secured basis.

17 For a discussion of priority, see *supra* note 14~~14~~.

18 PPSA, *supra* note 1, s 34(2).

19 The procedural elements referred to include registration of a financing statement with respect to the collateral within 15 days of possession for most collateral. For intangibles, registration of a financing statement with respect to the collateral within 15 days of attachment is required. "Intangible" is defined in the PPSA. PPSA, *ibid*, s 1, *sv* "intangible". For inventory, notice to all parties with potential prior secured parties with respect to the collateral and the registration of a financing statement with respect

security interest will have priority over every other security interest in the collateral granted by that debtor.[20] The reason for this reversal of the general priority rule[21] is that the PMSI is a new asset, in which the reversal of priority is not damaging to the interest of the all present and after-acquired property security interest holder.

This rationale is based on three assumptions. First, if the all present and after-acquired property security interest holder had lent the money, there would have been no need for the PMSI holder to extend credit. Therefore, this opens further credit options for the debtor.

Second, rather than damaging the interest of the holder of the all present and after-acquired property security interest, the new asset subject to a PMSI increases the size of the total pool of assets available to both the debtor (in good times), and to the secured creditors (in the event of default by the debtor). If the particular transaction at issue does not have this effect of increasing the pool of assets available in this sense, it will not be considered a PMSI.[22]

Third, since the all present and after-acquired property security interest would rank directly behind any PMSI holder with respect to the collateral subject to the PMSI,[23] each payment made with respect to the collateral subject to the PMSI would leave more collateral for the all present and after-acquired property security interest holder,[24] or at the very least should leave no less collateral for the all present and after-acquired property security interest holder.[25]

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to the collateral prior to possession being acquired by the debtor. "Inventory" is defined in the PPSA. PPSA, *ibid*, s 1, *sv* "inventory".

20 *Ibid*, s 34(2).

21 *Ibid*, s 35(1).

22 On this point, see e.g. *Wheatland Industries (1990) Ltd v Baschuk* (1994), 127 Sask R 178 at paras 15-16, 8 PPSAC (2d) 247 (Sask QB), *per* Justice Gerein, as he was then was.

23 It is quite clear that many concepts under the PPSA, including priority, are determined on each individual piece of collateral, not the global asset base of the debtor.

24 This is true in the sense that with each payment made with respect to the asset that is subject to the PMSI, the amount owing to the holder of the PMSI is reduced, and the debtor's equity in that asset is concomitantly increased, thereby increasing the security of the all present and after-acquired property security interest holder.

25 Even if the value of the asset that is subject to a PMSI decreases more quickly than the payments that being made to repay the creditor, the fact remains that without the

V. WHAT ARE PROCEEDS?

Proceeds are personal property that result from a dealing by the debtor with respect to the collateral,[26] provided that the proceeds are either identifiable or traceable to the original collateral.[27] For example, imagine that a debtor has financed the purchase of a stove as part of a restaurant business. The Bank has provided the financing. Later, an appreciative customer gives an even newer and better stove to the restaurant.[28] Therefore, the restaurant wants to sell the financed stove, and does so to another restaurant just outside of town. The second restaurant pays the first restaurant by cheque. The cheque is cashed into the first restaurant's bank account. The cash is then withdrawn by the first restaurant, and used to purchase new coffee pots for the business. All of the following will be proceeds of the stove:

i. the cheque - defined as an "instrument" under the PPSA;[29]
ii. the bank account into which the cheque was deposited - defined as an "account" under the PPSA;[30]
iii. the cash - defined as "money" under the PPSA[31] and
iv. the coffee pots - defined as "equipment" under the PPSA.[32]

The dealing may or may not be authorized[33] by the secured party.[34] If the dealing is authorized,[35] the rights of the secured party are different

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PMSI, the collateral subject to the PMSI would never have been added to the asset pool. In any event, it would therefore not have been available to the all-present and after-acquired property security interest holder.

26 PPSA, *supra* note 1, s 1, *sv* "proceeds".

27 Cuming, Walsh & Wood *supra* note 7 at 552-584, particularly at 555-556, and at 566-567.

28 In this scenario, the new stove would not be proceeds of the older stove, because the debtor acquisition of the new stove did not result from a dealing with the old stove. For a discussion the term "dealing" in this context, see Cuming, Walsh & Wood, *ibid*, at 565-566.

29 PPSA, *supra* note 1, s 1, *sv* "instrument".

30 PPSA, *ibid*, s 1, *sv* "account".

31 PPSA, *ibid*, s 1, *sv* "money".

32 PPSA, *ibid*, s 1, *sv* "equipment".

33 The authorization may be express or implied. On this point, see Cuming, Walsh & Wood *supra* note 7 at 560-562.

34 PPSA, *supra* note 1, s 28.

35 For a discussion of the meaning of authorization in this context, see e.g. *Lanson v*

than if it is unauthorized.[36] Regardless, the PPSA does not itself prevent the debtor from selling the collateral to a third party.[37] The important thing to remember at this point is that the debtor can dispose of the collateral without the permission of the secured party. This may transfer the property in the collateral, even if the security agreement may specifically prohibit it.[38]

VI. HOW CAN THERE BE TWO PMSIS IN THE SAME COLLATERAL?

There are a number of ways that this can arise. For present purposes, the scenario envisioned by the priority rule referred in subsection 34(7) is as follows: Debtor purchases an industrial stove for commercial use by Debtor from Creditor #1. This is done on credit, and Creditor #1 is the seller of the stove, and properly registers a financing statement against the name of the debtor, within 15 days of the debtor taking possession of the collateral. Pursuant to subsection 34(2), therefore, Creditor #1 has taken a PMSI in a good that is not inventory,[39] and should defeat all other security

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Saskatchewan Valley Credit Union Ltd (1998), 172 Sask R 106, 14 PPSAC (2d) 71, (CA) *per* Justice Vancise, for the Court.

36 If a dealing is authorized, for example, the dealing will cut off the security interest in the original collateral. This will leave the secured party with an interest in the proceeds of the original collateral. If the dealing is not authorized, on the other hand, the security interest will generally continue in the original collateral (subject to certain exceptions) and the proceeds thereof as well. See PPSA, *supra* note 1, s 28.

37 Of course, the parties to the security agreement may agree as between themselves that the sale of the collateral is not permitted. The security agreement is the agreement to provide the security interest. See PPSA, *supra* note 1, s 1, *sv* "security agreement". The relationship between the parties to the security agreement is determined by the rules relating to contract. PPSA, *supra* note 1, s 9. The parties to the security agreement are the debtor and the secured party.

38 On this point, see e.g. *Royal Bank of Canada v Gatekeeper Leasing Ltd* [1994] 6 WWR 706, 17 DLR 305, *per* Justice Dorgan. Some authors even say that in order for the dealing to not be authorized, the dealing by the debtor must be "wrongful". On this point, see Cuming, Walsh and Wood *supra* note 7 at 560-562.

39 It is the debtor's intended use of the good as at the date of attachment that determines whether a good is categorized as consumer goods, inventory, or equipment. See PPSA, *supra* note 1, s 2(2). "Consumer goods", "inventory", and "equipment" each has its own definition within the PPSA. See PPSA, *supra* note 1, s 1, *sv* "consumer goods", "inventory", and "equipment", respectively.

interest granted by Debtor in the stove. After four years, Debtor still has not completely paid off the stove. Nonetheless, Debtor wishes to trade in the stove on a newer model. Creditor #2 has offered to accept a trade-in of the older model on the newer model, and will allow Debtor to finance the remainder of the purchase-price of the newer model.

The newer model is clearly "proceeds" of the older one within the meaning of the PPSA, in that it is personal property resulting from a dealing with collateral (the older model). Therefore, where there is a PMSI in the original collateral, and that collateral is dealt with and generates other personal property (in this case, the newer model), the creditor gets a PMSI in the proceeds as well. This is what is known as a "proceeds PMSI". Therefore, when the debtor disposed of the older model, Creditor #1 acquired a PMSI in the proceeds of the disposal, namely, the newer model. Therefore, Creditor #1 has a proceeds PMSI in the newer model. The PMSI in the older model may or may not continue (depending on whether the dealing is authorized). It is considered a PMSI in the original collateral, and also known as a "non-proceeds" PMSI. Therefore, the proceeds provisions of the PPSA give Creditor #1 both:

i. a proceeds PMSI in the newer model; and
ii. a non-proceeds PMSI in the older model.

However, Creditor #2 is the seller of the newer model. Since Creditor #2 sold the good and took a security interest in the newer model, as long as Creditor #2 properly registers a financing statement against the name of the debtor, within 15 days of the debtor taking possession of the collateral, Creditor #2 is also entitled to the priority provided for in subsection 34(2) of the PPSA.

In other words, both Creditor #1 and Creditor #2 both hold PMSIs in the same collateral of Debtor, namely, the newer model stove, while only Creditor #1 holds a PMSI in the older model. Subsection 34(2) does not break this tie, because it only provides that a properly registered PMSI beats any other security interest in same collateral. It does not distinguish between two different security interests, both of which are PMSIs, in the same collateral.

Subsection 34(7) is designed to break the tie between two PMSIs in the same collateral, one of which is proceeds of a PMSI in other collateral, the other of which is a PMSI taken in the original collateral. In such a case, the non-proceeds PMSI beats the PMSI that arises as proceeds.

VII. WHY IS THIS THE PROPER CHOICE FROM A POLICY PERSPECTIVE?

In the view of the author the reasoning behind the priority rule provided in s 34(7) is sound. Creditor #1 has a fair degree of control over the terms of the security agreement between Creditor #1 and Debtor. Therefore, Creditor #1 can negotiate to have a provision included in that agreement which provides that any disposal of the older model stove without the express, written consent of Creditor #1 is a violation of the security agreement between Creditor #1 and Debtor. Therefore, when Debtor trades in the older model stove, this is a dealing that is not authorized. As a result, the wording of the proceeds provision would continue to give Creditor #1 first priority on the older model stove and Creditor #1 would be second in priority to Creditor #2 on the newer model stove.

On the other hand, if s 34(7) were not present there would be no special priority rule to break the tie. In the absence of such a rule the general priority rule would govern. Since both interests were perfected by registration, the first to register would win the priority contest.[40] In the hypothetical posited here, Creditor #1 would rank first on the newer model stove.

Yet, as mentioned earlier, Debtor would never have had rights in the newer model stove without the credit provided by Creditor #2. Furthermore, if Creditor #1 had wanted to maintain priority over the newer model stove, Creditor #1 could have provided either vendor (by selling the newer model stove to Debtor) or lender credit (by lending Debtor the money to buy the newer model stove) to Debtor. In either case, Creditor #2 would not have had a PMSI, and could not assert priority.

Finally, this is consistent with the doctrine of *marshalling*.[41] In this case, where one creditor (Creditor #1) has an interest in two pieces of property (the older model stove and the newer model stove), and another creditor (Creditor #2) has an interest in only one of the two pieces of property (in this case, the newer model stove), the one creditor, in realizing

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40 PPSA, *supra* note 1, s 35(1).

41 For a discussion of marshalling, see, for example, *Holnam West Materials Ltd v Canadian Concrete Products Ltd*, 8 PPSAC (2d) 102, [1995] 1 WWR 155 (Alta QB), *per* Justice Bielby (as she then was).

on its security should leave as much of the collateral of the other creditor untouched, rather than attempting to realize on the collateral in which both secured creditors have an interest, until the value in the other available is exhausted.[42] This strategy achieves the maximum benefit for all secured creditors of the debtor. Subsection 34(7) achieves largely the same goal, in that it does not leave Creditor #2 without a source of recovery, while still leaving Creditor #1 with collateral on which it is also first in priority, namely, the older model stove.[43]

In the end therefore, the law generally seeks to protect those who cannot protect themselves. It does not generally seek to protect those who could have protected themselves, but chose not to do so. Creditor #1 could have protected its own interests through the proper drafting of its security agreement with Debtor. It did not do so. If Creditor #1 ranks first in priority on the newer model stove, Creditor #2 will have no collateral on which it has a first priority. Creditor #2 could not have protected itself any better under the PPSA. Creditor #1 could have better protected itself, however. Therefore, to encourage Creditor #1 to properly draft its security agreement with Debtor, Creditor #2 should win the priority competition with Creditor #1 with respect to the newer model stove. Subsection 35(7) therefore achieves the proper result, from a policy perspective, in the view of the author.

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42 Marshalling is an equitable doctrine, but it may be used to the extent that it is not inconsistent with the express provisions of the PPSA. On this point, see PPSA, *supra* note 1, s 65(2), and see Cuming, Walsh & Wood *supra* note 7 at 676-678.

43 It is also to be remembered that the creation of the proceeds PMSI was, at least from the point of Creditor #1, a fortuitous event. Creditor #1 did not cause, through its actions, the proceeds to be created. Rather, it was the actions of Debtor and Creditor #2 that led to Debtor having rights in the newer model stove. Without the actions of Debtor and Creditor #2, Creditor #1 would have been restricted to the older model stove in any event. Instead, Creditor #1 is able (with a properly drafted security agreement) to maintain its interest in the older model stove, and take an interest in the newer model stove, although this interest will rank behind that of Creditor #2. Therefore, Creditor #1 can hardly claim to be prejudiced by this outcome.