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Secured Parties Beware: Security Interests in Transferred Collateral

Jeffrey Alpert
Partner, Banking & Financial Services

PHONE
416 777 5418

EMAIL
jalpert@torkinmanes.com

Jeffrey is a partner in our Banking, Finance & Insolvency Law Group. He acts for banks and other lenders, and for borrowers in commercial loan transactions secured by real estate and personal property. He has extensive expertise in asset-based lending and factoring, including receivables purchase financing.

Introduction

The decision of the Ontario Court of Appeal in *Lisec America Inc. v. Barber Suffolk Ltd.* (2012), 86 C.B.R. (5th) 316 and 94 C.B.R. (5th) 16, should serve as a warning to all secured parties regarding the risks involved in taking a security interest in collateral which is subsequently transferred by the debtor to a transferee without the prior consent of the secured party. In this case, a supplier took a purchase money security interest in equipment that it sold to the debtor. The debtor subsequently transferred the equipment to a related corporation without the consent of the supplier and without notifying the supplier about the transfer. The transferee then granted a security interest in the equipment to another secured party who registered a financing statement against the transferee under the *Personal Property Security Act,* R.S.O. 1990, c.P.10 (the "PPSA"). After the supplier found out about the unauthorized transfer of the equipment, the supplier registered a financing change statement against the transferee under the PPSA within 30 days after learning about the transfer in accordance with section 48(2) of the PPSA. The Ontario Court of Appeal held that the supplier's security interest took priority over the secured party's interest in the equipment. In reaching this decision, the Court considered the rationale behind the PPSA and whether the supplier or the secured party should bear the loss involved in financing the equipment.

The Facts

The facts of the case were as follows:

1. The Barber Glass group of companies were in the business of supplying glass products. Barber Suffolk Ltd. ("Suffolk") and Barber Glass Industries Inc. ("Glass") were related companies in that group.
2. On July 16, 2007, Lisec America Inc. ("Lisec") sold a waterjet glass cutting machine (the "Waterjet") to Suffolk pursuant to an equipment purchase agreement which provided for a purchase money security interest (a "PMSI") in favour of Lisec.
3. On the same date, Lisec also sold two additional pieces of

equipment to Glass.

4. On the same date, unbeknownst to Lisec, Suffolk in turn sold the Waterjet to Glass.
5. On June 19, 2008, Lisec perfected its security interests by registering a PPSA financing statement against Suffolk with respect to the Waterjet and a PPSA financing statement against Glass with respect to the other two pieces of equipment.
6. On June 28, 2008, Lisec delivered all three pieces of equipment to the facilities of Glass in Collingwood, Ontario.
7. Around the time of the above delivery, Glass was looking for additional financing. Glass approached Lisec and asked Lisec to release its security interests in the Glass equipment so that Glass could obtain additional financing from Roynat Capital Inc. ("Roynat").
8. On June 24, 2008, Roynat registered a PPSA financing statement against Glass.
9. On July 7, 2008, Glass executed a debenture in favour of Roynat, which debenture specifically granted Roynat a security interest in the Waterjet.
10. On July 9, 2008, Lisec discharged its PPSA registration against Glass, at the request of Glass and Roynat.
11. Some of the indebtedness of Glass to Lisec was repaid out of the funds advanced by Roynat.
12. On November 10, 2010, Glass was placed in receivership. Shortly thereafter, Lisec learned for the first time that Suffolk had earlier sold the Waterjet to Glass and that the Waterjet was considered in the receivership as an asset of Glass.
13. On November 17, 2010, Lisec claimed a PMSI in the Waterjet and on November 29, 2010, Lisec registered a financing change statement showing Glass as the new debtor in respect of its security interest in the Waterjet.
14. As part of the receivership proceedings relating to Glass, the receiver was seeking to sell the assets of Glass, including the Waterjet.
15. Lisec objected to the inclusion of the Waterjet in the asset sale and applied to the Ontario Superior Court of Justice for a determination of its right and entitlement in the Waterjet.

Section 48(2) of the PPSA – Transfer of Collateral without Prior Consent

Both the decisions of the application judge and the Ontario Court of Appeal involved the consideration of section 48(2) of the PPSA which provides as follows:

> "Where a security interest is perfected by registration and the debtor, without the prior consent of the secured party, transfers the debtor's interest in all or part of the collateral, the security interest in the collateral transferred becomes unperfected thirty days after the later of,
>
> (a) the transfer, if the secured party had prior knowledge of the transfer and if the secured party had, at the time of the transfer, the information required to register a financing change statement; and
>
> (b) the day the secured party learns the information required to register a financing change statement,
>
> unless the secured party registers a financing change statement or takes possession of the collateral within such thirty days."

The Reasons of the Application Judge

The application judge held that the transfer of the Waterjet from Suffolk to Glass did not terminate Lisec's security interest in the Waterjet. The application judge also held that even though Lisec named Suffolk (not Glass) in its PPSA registration, section 48(2) of the PPSA applied and therefore Lisec's security interest did not become unperfected as a result of the unauthorized transfer. However, the application judge found that Lisec's discharge of its PPSA registration against Glass unperfected Lisec's PMSI in the Waterjet because Lisec had registered a financing statement against Glass, because the wording of the financing statement was broad enough to

capture the Waterjet as well as the other two pieces of equipment sold by Lisec to Glass, and because Lisec had discharged the Glass registration without qualification. Accordingly, the application judge ruled in favour of Roynat. Lisec appealed from that order.

The Decision of the Ontario Court of Appeal

The Ontario Court of Appeal allowed Lisec's appeal and ruled in favour of Lisec. The Court declared that Lisec's security interest in the Waterjet ranked first in priority to Roynat's security interest in the Waterjet.

The Court of Appeal agreed with the application judge that the unauthorized transfer of the Waterjet from Suffolk to Glass did not unperfect Lisec's security interest in the Waterjet, because Lisec properly registered a financing statement against Glass within 30 days after learning about the transfer. The Court of Appeal described the purpose of section 48(2) of the PPSA as follows:

> "The purpose of this provision is to protect creditors who have taken all proper steps to perfect their security under the PPSA from losing their priority because of an unknown transfer of the protected asset to another debtor. Since the PPSA regime protects priority by means of registration against the name of the debtor, the Act provides the secured party in such circumstances with a grace period after becoming aware of the transfer to preserve its priority by registering a financing change statement against the new debtor as well. Accordingly, since Lisec registered its financing statement within 30 days of learning the information required to do so, the effect of s.48(2) is that Lisec's security interest in the Waterjet – as protected by the Barber Suffolk registration – remain perfected and entitled to priority over any registrations made against Barber Glass, and covering the same collateral, during the period between the transfer and the registration of Lisec's subsequent financing change statement."

The Court of Appeal then proceeded to consider the effect of the discharge by Lisec of its PPSA registration against Glass, a registration that was never intended to apply to the Waterjet, which, in the words of the Court of Appeal "muddies the waters". It disagreed with the application judge's conclusion that the effect of Lisec's discharge of its PPSA registration against Glass on July 9, 2008, was to unperfect Lisec's PMSI in the Waterjet. The Court of Appeal acknowledged that Lisec and Roynat were both innocent providers of credit and that one of them would suffer a loss as a result of the priority determination. It noted that Lisec had no reason to believe that the contested collateral, namely, the Waterjet, would be included in the assets of Glass over which Lisec had agreed to release its security interest. On the other hand, Roynat advanced its funds and perfected its security interest in the collateral of Glass without knowing that Lisec claimed a security interest in Waterjet. Ironically, Roynat had every reason to believe that Lisec did not have any security interest in the Waterjet, since Lisec had expressly discharged its PPSA registration against the collateral of Glass at Roynat's request before Roynat advanced its funds.

The Court of Appeal determined that the security interest of Lisec took priority over the security interest of Roynat in the Waterjet for two reasons:

1. Lisec's interest in the Waterjet did not attach through Lisec's PPSA registration against Glass. Suffolk and Glass each executed equipment purchase agreements in favour of Lisec granting security interests in specific pieces of equipment – in the case of Suffolk, the Waterjet, and in the case of Glass, two other pieces of equipment. Glass never signed a security agreement granting Lisec a security interest in the Waterjet. The fact that Glass ultimately became the owner of the Waterjet did not alter this result. Since Lisec's PPSA registration against Glass did not cover the Waterjet, neither the above PPSA registration nor its discharge could have any impact on the operation of the provisions of s.48(2) of the PPSA in preserving the priority of Lisec's security interest in the Waterjet.
2. The Lisec PPSA registration and discharge against Glass were irrelevant in any event. Lisec's PPSA registration against Suffolk was a stand-alone registration,

> which was not dependent upon nor it was replaced by Lisec's PPSA registration against Glass. Lisec's PPSA registration against Suffolk remained in place and remain perfected at all material times as a result of the operation of s.48(2) of the PPSA. In the words of the Court, the Lisec PPSA registration against Glass and the subsequent discharge of the above registration were "red herrings".

The Court of Appeal referred to the decision of the Supreme Court of Canada in *Royal Bank v. Sparrow Electric Corp.* (1997), 44 C.B.R. (3d) 1, in which it was stated that the purpose of the PPSA is to "increase certainty and predictability in secured transactions through the creation of a coherent system of priorities."

The Court of Appeal acknowledged that the position of Roynat was a difficult one and stated as follows:

> "It is true that lenders in the position of Roynat are vulnerable in situations such as this case presents. But the legislature has given a clear indication through the operation of s.48(2) of the PPSA that lenders in the position of Lisec are to prevail. There is no lack of certainty or predictability when the provisions of the Act as a whole are properly applied."

Conclusions

This case demonstrates some of the risks involved in taking security in personal property in Ontario. Unlike the land registry system for real property, there is no way in Ontario to search the title to personal property in order to determine the ownership of personal property, such as machinery and equipment. At the time that Lisec registered its PPSA financing statement against Suffolk, Lisec believed that Suffolk was the owner of the Waterjet and did not know that Suffolk had sold and transferred the Waterjet to Glass. Similarly, at the time that Roynat registered its PPSA financing statement against Glass, it believed that Glass was the owner of the Waterjet and did not know that Glass had acquired the Waterjet from Suffolk subject to the prior security interest in favour of Lisec.

How were Lisec and Roynat supposed to protect their respective security interests under these circumstances? Section 48(2) of the PPSA is intended to protect secured parties like Lisec from a transfer of the collateral without their consent by maintaining their security interest in the collateral following the transfer until the expiration of the 30 day grace period following the date that the secured party becomes aware of the transfer and learns the information required to register a financing change statement. According to the Courts, the purpose of this approach is to increase certainty and predictability in secured transactions through the creation of a coherent system of priorities. A secured party in the position of Lisec is under no obligation to make inquiries as to whether its debtor still owns the collateral. However, as soon as the secured party becomes aware of a transfer that was made without its prior written consent, the secured party must ensure that it maintains its security in the transferred collateral by complying with the provisions of s.48(2) of the PPSA. Lawyers acting for secured parties should refer to these requirements in their reporting letters to their clients.

For a lender in Roynat's position, there is, unfortunately, no real way to protect itself from a priority claim of a secured party in Lisec's position. In theory, Roynat could have tried to protect itself by making inquiries as to the chain of title of all of the machinery and equipment apparently in the possession and ownership of Glass. As a practical matter, these types of inquiries are seldom made because there is no system in Ontario for searching the ownership of personal property. In these sorts of commercial transactions, lawyers should make their lending clients aware of the limitations of the PPSA. Lender's counsel shall also qualify their legal opinions by noting that the enforceability of security agreements is subject to the provisions of the PPSA.

Some lenders may ask their lawyers to provide a legal opinion that the debtor owns its personal property and that the lender has a first priority security interest in the debtor's personal property. In response to this request, lenders' counsel should advise their clients that it is not the practice in Ontario to provide such opinions in connection with security over personal property. Lenders'

counsel should search against the debtor under the PPSA and advise their clients regarding all of the outstanding registrations against the debtor. The lender must then decide whether it will treat these registrations as prior permitted encumbrances, or whether these registrations should be discharged or postponed in favour of the lender's registration.

The PPSA is complex legislation. This case is another reminder that taking security in a debtor's personal property is subject to certain risks inherent in the PPSA, including the risk of prior security interests in transferred collateral.