

LIMITATIONS IN USE OF PURCHASE-MONEY SECURITY INTEREST IN CROSS-COLLATERALIZATION

A recent decision of the Alberta Queen's Bench¹ has raised some questions about purchase-money security interest ("PMSI") proceeds and cross-collateralization of assets secured by these types of security interests. It has been suggested that this decision is unique and establishes that using a PMSI as collateral for other indebtedness of the debtor is dangerous. But is this decision really so radical?

Facts:

The Receiver of Ramco Sales Inc. ("Ramco"), an equipment supplier, sought a declaration that it was entitled to the equity remaining after it sold four pieces of equipment in which Canadian Western Bank ("CWB") had a PMSI. The four pieces of equipment had been purchased by the insolvent Ramco with monies provided by CWB pursuant to a loan agreement and security. The security interest was in items specified in Schedule "A" and in subsequent schedules. Attached to the master agreement were 13 schedules. The equipment at issue was in Schedules 1, 6, 7 and 8 and the schedules spanned about 15 months. CWB was also owed monies with respect to other equipment. Royal Bank of Canada ("Royal Bank") had a prior registered general security agreement ("GSA").

Issue:

The major issue addressed by the Court was who was entitled to the remaining equity in the four items of equipment after each item had been sold. CWB argued that any surplus after each piece of equipment had been disposed of should be used to pay off any remaining indebtedness on the other three, with the balance directed to its general loan. Royal Bank and the Receiver argued that each piece of equipment was discreet. If there was any surplus after the sale of that item, the surplus should go to the Receiver.

¹ Royal Bank of Canada v. Ramco Sales Inc. 2010 ABQB1



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Decision:

The Court considered Section 61 of the Alberta *Personal Property Security Act* (“PPSA”) (similar to Section 64 of the Ontario *Personal Property Security Act*). It looked at each item of equipment as collateral for the loan and determined that Section 61 provides that if there is any surplus after the collateral has been disposed of, it goes first to the party with a subordinate security interest to the PMSI. In this case, it was Royal Bank with its prior registered GSA.

The Court went on to consider why a PMSI takes priority over a prior secured creditor who has an “after-acquired property clause” and commented upon a major characteristic of a PMSI; that it be limited to loans made that can be traced to identifiable discreet items of property. “The purpose of the PPSA is to provide an ordered regime to facilitate commerce in a balanced way for a debtor and its creditors. To permit a PMSI creditor to use surplus funds from an identifiable existing asset to pay off debt with respect to other identifiable existing assets or any deficiency with respect to assets no longer available would upset the balance...” and the “PMSI creditor would usurp the priority of the prior secured creditor”.

Discussion:

In the circumstances the decision is reasonable. Although the decision itself does not set out a great many facts, we know that each of the four pieces of equipment was described in a separate schedule and we can extrapolate therefore that each had a separate payment schedule. Each piece of equipment was sold separately. So the Receiver could determine the amount of the deficiency after the sale of each item of equipment. Compare this with a security agreement wherein four items of equipment are described in one schedule, with a blended payment and the same right to apply payments to the indebtedness in such manner as the secured party determines in its discretion, as CWB could in respect of Ramco. On the sale of these four items of equipment, either individually or as a package, the surplus would still rightly go to the prior secured creditor with a general security agreement. This is the concept afforded to a PMSI by the statute.

While it has been suggested to avoid this type of situation, with collateral that is cross-collateralized and subject to a PMSI, that secured creditors should obtain a waiver from existing prior secured creditors, it may not be appropriate nor in fact feasible, to have a prior secured creditor, like a bank, agree to waive their security interest in the surplus or agree that any surplus in respect of

equipment secured by a PMSI may be applied to the shortfall in respect of other PMSI-secured assets or to the balance of a (subsequently secured) loan. After all, the definition of a PMSI is “a security interest taken or reserved in collateral, other than investment property, to secure payment of all or part of its (underlining mine) price”.

The Court in Alberta comments that counsel arguing the Ramco case agreed that there were no authorities on this issue of priorities. There are, however, two earlier Ontario decisions that considered the surplus question when a PMSI asset was sold. The first, *Superior Coatings Canada Ltd. v. Peat Marwick Thorne Inc.*² was first determined by the Ontario Court of Justice (General Division). The lower court did not specifically address the issue of the surplus but determined that the receiver or trustee could withhold from the funds realized on the sale of the assets of the debtor and payable to a PMSI creditor, the expenses of the receiver or trustee and did not need to account for any surplus to subordinate secured creditors. The Court of Appeal³ allowed the appeal of the second ranked secured party. Briefly, the Court of Appeal determined that the receiver was the agent of the first secured party in effecting the sale and holds the surplus as agent. The PPSA required surplus funds from a sale by one secured creditor to be paid to the next secured creditor. Therefore, although the priority issue had not been specifically addressed in respect of a PMSI creditor, the general concept had been considered, with the PPSA providing for an orderly distribution of proceeds.

A similar decision was made by the Court of Appeal when it reconsidered *Canadian Imperial Bank of Commerce v. International Harvester Credit Corporation of Canada Ltd.*⁴ In this instance, the prior secured creditor had a perfected security interest in leased vehicles, with the Bank subsequent, with a fixed and floating charge in a debenture. The lower court⁵ determined that the lessor had priority over the Bank because the Bank’s debenture contained a subordination clause allowing the debtor to deal with the vehicles. In addition, at the Ontario Supreme Court, the judge determined that the lessor should receive all proceeds from the sale of a specific vehicle, even though those proceeds exceeded the amount due and owing in respect of the vehicle. The Court of Appeal in overturning this decision, decided that the lessor’s priority was restricted to the amount owing on the loan in respect of the specific

² 4 P.P.S.A.C. (2d) 10

³ 10 P.P.S.A.C. (2d) 218 (Ont. C.A.)

⁴ 6 P.P.S.A.C. 273 (Ont. C.A.)

⁵ 4 P.P.S.A.C. 329

vehicle with the excess being part of the funds owed to the Bank under the debenture.

Although these two Ontario decisions considered other matters in addition to the question of surplus, both reached a similar conclusion as in Ramco when a specific item of collateral has been sold. Any surplus after

payment for the specific discreet item is to be paid to the subsequent secured creditor.

Therefore, although the Ramco decision specifically addresses PMSI proceeds and the surplus arising from the sale of discreet items of equipment, it merely reinforces the provisions and the priorities scheme in the PPSA for a systematic distribution of proceeds.

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