Modernizing the Purchase-Money Security Interest

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Submitted by: **The Ontario Bar Association, Personal Property Security Law Committee**

ONTARIO BAR ASSOCIATION
A Branch of the Canadian Bar Association

L'ASSOCIATION DU BARREAU DE L'ONTARIO
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The Ontario Bar Association ("**OBA**") appreciates the opportunity to provide advice to the Government on reforming the law of purchase-money security interests ("**PMSIs**") an important initiative that we believe will modernize the *Personal Property Security Act* ("**PPSA**"). As set out below, PMSIs are an important method of allowing sellers and lenders to take a security interest in a personal property. Our proposed reforms would provide for greater certainty: when there are both PMSI and non-PMSI security interests in the same collateral; when the PMSI secures multiple interests; and when determining allocation of payments among different types of obligations. These changes would provide greater commercial efficiencies, generally reduce bookkeeping requirements and make PMSIs a more effective security feature. Below you will find a description of the OBA proposal with recommended statutory amendments set out at Appendix A.

The OBA

Established in 1907, the OBA is the largest legal advocacy organization in Ontario, representing 18,000 lawyers, judges, law professors and law students. We advocate both in the interests of the profession, and, as in this case, in the interests of the public. The OBA's Business Law Section has nearly 2000 members and its Personal Property Security Law Committee ("**PPSLC**") includes the leading experts in the field. The PPSLC members would count among their clients virtually every stakeholder in the personal property security regime including lenders, borrowers, financial institutions, derivatives counterparties and regulators. The OBA's Business Law Section and PPSLC have assisted government with virtually every reform of the PPSA.

OBA Recommendation

PMSI Overview

PMSIs are a subset of security interests in property under the PPSA. A security interest in collateral (the term used in the PPSA for property subject to a security interest) is a PMSI if it is taken by a seller of personal property to secure payment of the sale price of that collateral, or taken by a lender if the loan is made specifically to allow the debtor to obtain that collateral with the loan proceeds. The interest of a lessor of goods in a lease with a term of more than one year is deemed to be a security interest and deemed to be a PMSI. The PMSI regime is not applicable to security interests in investment property, or to transactions which are sale and leasebacks (transactions in which the property is sold by a seller to a buyer and then leased by the buyer to the seller).

Once a security interest is determined to be a PMSI, it is given a special priority status if certain steps are taken by the secured party. Those steps and the priority results are set out in section 33 of the PPSA. If those steps are taken, the PMSI will have priority over any other security interest given in the same collateral by the same debtor – so, significantly, even if a prior perfected security interest exists that would cover the PMSI collateral. The reasons for the existence and special priority status of the PMSI concept include a desire to prevent secured creditors from obtaining "situational monopolies" in which the debtor would effectively be prevented from obtaining credit from any other financer to acquire new property.[1]

Purpose of this Proposal

The proposals outlined here are intended to address three long-standing issues that exist in connection with PMSIs:

1. Cross-collateralization by inventory financers
2. The status of renewed, refinanced, consolidated, restructured or "mixed" PMSIs; and
3. The allocation of payments.

Addressing these issues will provide greater commercial efficiencies, generally reduce bookkeeping requirements and make PMSIs a more effective security instrument. In developing our proposal we have considered recommendations and concepts from the Uniform Commercial Code in the U.S. (the "**UCC**"); the Canadian Conference on Personal Property Security Law[2] (the "**CCPPSL**"); and recent amendments to the Saskatchewan PPSA[3] based on the CCPPSL recommendations. The individual issues addressed are discussed in detail below; the specific changes we propose to the PPSA to implement them are attached as Appendix A.

Cross-collateralization by inventory financers

As outlined above, the PMSI concept relates to the provision by the secured party of the "purchase-money" for collateral, either by selling (or leasing) that collateral or extending credit for the specific purpose of acquiring it. This concept, and the definition of PMSI, is inherently collateral-specific and requires an item-by-item assessment. This creates difficulties in more complex financing arrangements where PMSI and non-PMSI security interests exist in the same collateral,

[1] The classic statement of the justification for the PMSI regime can be found in Jackson and Kronman, "Secured Financing and Priorities Among Creditors" (1979), 88 Yale L.J. 1143.
[2] See "Report to the Canadian Conference on Personal Property Security Law on Proposals for Changes to the Personal Property Security Acts", ratified at the CCPPSL's Annual Meeting of June 21-23, 2017 (the "**CCPPSL Report**"); available at 2017 CanLIIDocs 3526, <http://www.canlii.org/t/sl12>, retrieved on January 24, 2020.
[3] See the amendments in *The Personal Property Security Amendment Act, 2019*, S.S. 2019, c.15.

perhaps in favour of the same secured party, or where outstanding secured obligations may exist relating to both PMSI collateral and other collateral.

In particular, in inventory financing arrangements it is common that a relationship exists between the financer and the debtor which involves periodic delivery of items of inventory on credit terms, requirements to repay when financed items are sold by the debtor from its inventory, or perhaps to repay in part as time passes even where they are not sold ("curtailments"), allocations of payments agreed between the financer and the debtor, and grants of security over the debtor's inventory generally to secure all obligations to the financer, not just the unpaid obligations in respect of specific items ("cross-collateralization"). Because of the different priority positions involving PMSI and non-PMSI collateral, this can create complex situations which would require significant item-by-item recordkeeping by the secured party and debtor to determine priorities.

An example[4] illustrates the issue:

- A debtor (D) deals both with a bank (B) and a supplier of inventory on credit terms (S).
- D grants a security interest in all of its present and after-acquired personal property to B, and B properly perfects that security interest by registration.
- S begins to supply items of inventory to D. Before doing so, it takes from D a security agreement which creates a security interest in all items of inventory supplied to secure all unpaid amounts owed by D to S. S properly perfects that security interest by registration and delivers a notice to B that it has or will acquire a security interest in D's inventory as set out in subsection 33(1) of the PPSA.
- S supplies two items of inventory to D, items #1 and #2.
- Item #1 is sold by D. Now, as between S and B, the priority position as to item #2 may depend on how D's payment to S is allocated (or indeed whether such payment is made).
    - If D's obligation with respect to item #1 is repaid in full and nothing is applied to the obligation respecting item #2, then the outstanding amount due to S with respect to #2 is fully secured by a PMSI in #2, and S will have priority.
    - If D's obligation with respect to item #1 remains outstanding but the obligation to S with respect to item #2 is fully repaid, then while S still has a security interest in item #2 (by cross-collateralization – the amount outstanding on item #1 is secured by a security interest in item #2) that security interest is (arguably, on the current wording of the PPSA) not a PMSI.[5] B will (arguably) have priority by order of registration.

[4] This example is adapted from that in the CCPPSL Report, Section II(2)(a), pages 18-19.

[5] Contrast the result in *Chrysler Credit Canada Ltd. v. Royal Bank of Canada*, [1986] 6 WWR 338 (Sask.C.A.), which is criticized at Cuming, Walsh and Wood, *Personal Property Security Law* (2d ed.) (Irwin Law, 2012) at 455-456, and compare *Unisource Canada Inc. v. Hongkong Bank of Canada* (1998), 14 PPSAC(2d) 112 (Ont.Ct.Gen.Div.).

- If D's payment to S is allocated partly to the obligation with respect to item #1 and partly to the obligation with respect to item #2, then S's security over item #2 may have priority for the part of the outstanding obligation that relates to the unpaid obligation for item #2 but not for the part that relates to the unpaid obligation for item #1.

It can easily be seen how this situation can become unmanageably complex where multiple creditors are involved and many items of inventory are delivered (and their related obligations fully or partly repaid) at different times.

The proposal here, following that in the CCPPSL Report[6] and the amendments to the Saskatchewan PPSA, is to provide inventory financers with PMSI status for their cross-collateral security interests in supplied inventory, in addition to their security interests specifically tied to the unpaid obligations for that specific inventory. As in those earlier proposals, and unlike the position under the UCC,[7] that priority is limited to security interests taken in related transactions – that is, transactions contemplated in the scope of the inventory supply relationship and not separate, unrelated transactions between the inventory financer and the debtor. "Related transactions" are those which are contemplated at the time of the first transaction (for example, a supply contract in which multiple separate deliveries are contemplated over time) or which are all contemplated in an agreement entered into before the first transaction (for example, a master inventory sale agreement which sets out conditions for subsequent transactions, potentially by way of schedules to the master agreement). The proposal is implemented by adding new subsections (5) and (6) to section 1 of the PPSA and by amending the definition of "purchase-money security interest" in subsection 1(1) to refer to those new subsections.

Status of renewed, refinanced, consolidated, restructured or "mixed" PMSIs

Because the PMSI concept depends on the purchase-money financing being provided either by way of credit sale (deferral of payment of the purchase price of the collateral) or by way of financing that is applied to enable the debtor to acquire rights in the collateral, it is arguably limited in availability to the parties to the initial acquisition transaction. Where the original financing is replaced with new financing for the same obligation secured by the same collateral, there seems to be no valid policy reason not to give the replacement financer the same priority vis-à-vis the

[6] See CCPPSL Report, Section II(2), pages 18-25.
[7] The relevant provision of the UCC (§9-103(b)(2)) is similar in that it extends PMSI status to security interests that apply to inventory that "is or was purchase-money collateral" and secures obligations incurred with respect to other inventory "in which the secured party holds or held a purchase-money security interest" – but does not require any connection between the transactions.

collateral that the original financer had. However, because that financing will not be provided by a seller or used to allow the debtor to acquire rights in the collateral it does not already have, it is not certain that this would be the result.[8] In addition, there has been some uncertainty as to whether the status of a PMSI in collateral could be affected by either (i) the same collateral also being used as collateral for a non-purchase-money-related obligation or (ii) alternatively, other collateral also being used as security for the same purchase-money-related obligation.

The proposal here is to address all these issues. It follows the recommendations in the CCPPSL Report[9] and amendments made to the Saskatchewan PPSA.

Proposed new subsection 1(7) of the PPSA would simply declare that a PMSI does not lose its status because the purchase-money collateral also secures other obligations, or because the purchase-money obligation is also secured by other collateral. It also declares that the PMSI status is not lost because the purchase-money obligation is "renewed, refinanced, consolidated or restructured".

Where a replacement financing occurs, amendments to the priority provision relating to PMSIs (section 33) are intended to deal with any potential unfairness to competing secured parties. New subsections 33(4) and (5) provide that a refinancing secured party will be deemed to be the assignee of the original secured party under the PMSI if the original registration is amended to reflect the refinancing secured party as the secured party, or if the refinancing secured party completes a new registration or otherwise perfects the security interest. This latter provision reflects the fact that, in a competitive situation, the refinancing secured party may not be able to get the cooperation of the original secured party in order to amend the original registration or prevent the original secured party from discharging it. As against competing secured parties, the refinancing secured party keeps the original secured party's PMSI position – but (under new subsection 33(5)) if it is unable to complete an amendment to the original registration, it will need to provide written notice of the deemed assignment to other competing secured parties or be deemed subordinated to their new advances made after the expiry or discharge of the original registration and before such notice. This is intended to prevent a situation where a competing secured party which is aware of the original PMSI believes that it can rely on obtaining priority for new advances once the registration relating to that PMSI is discharged or expires, being unaware of the deemed assignment or any

[8] Compare, for example, *MacPhee Chevrolet Buick GMC Cadillac Ltd. v. SWS Fuels Ltd.*, 2011 NSCA 35, in which the PMSI provisions were read narrowly to deny a refinancer priority, with *Unisource Canada Inc. v. Laurentian Bank of Canada* (2000), 47 O.R. (3d) 616 (C.A.) and *Battlefords Credit Union Ltd. v. Ilnicki* (1991), 82 D.L.R. (4th) 69 (Sask.C.A.) in which refinancing and consolidation loans were held to be within the PMSI concept.
[9] See CCPPSL Report, Section II(3), pages 25-28.

subsequent perfection by the refinancing secured party. The burden is placed on the deemed assignee (the refinancing secured party) to provide notice in this situation.

Allocation of payments

In some circumstances, how payments by a debtor to a secured party are allocated may affect the rights of the parties in respect of other secured or unsecured obligations or the rights of other creditors as against the debtor or its property. The PPSA is today silent on the question of the manner in which payments are allocated, which could lead to uncertainty. Both the UCC and the Australian PPSA provide allocation methods, and the CCPPSL Report[10] recommends a method which is like that in the Australian PPSA.[11] The amendments to the Saskatchewan PPSA follow the CCPPSL recommendation and that approach is proposed here for the Ontario PPSA as well.

In essence, the proposal is to allow parties (that is, a debtor and secured party; the proposal does not affect payments outside of this context) to agree on how payments made will be allocated among various obligations, or failing agreement for the debtor to express an intention as to how payments are to be allocated before or at the time of making the payment. But if neither of these situations applies – a payment is made but there is no applicable agreement on its application and no expression of intention by the debtor – then the payment would be applied first to unsecured obligations, next to secured obligations which are <u>not</u> secured by PMSIs and finally to secured obligations which are secured by PMSIs.[12] This approach would leave outstanding the longest the obligations which are secured by the highest-priority security.

It is proposed to implement this by adding new section 72.1 to the Ontario PPSA.

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[10] See CCPPSL Report, Section II(4), pages 28-31.

[11] However, the provisions in the Australian PPSA apply only where at least one of the obligations in question is secured by a PMSI, and the CCPPSL proposal (and the proposal here) includes no such limitation. See Duggan, "Recent PPSA Reform Initiatives in Canada" (2017), 45 Aust.Bus.Law.Rev. 467.

[12] This approach is the one taken by all the provisions or proposals mentioned above except the UCC. The UCC (at §9-103(e)) is similar but reverses the last two allocation priorities, applying payments first to PMSI-secured obligations. See the discussion in the CCPPSL Report at Section II(4)(b), page 29.

Appendix A

Proposed amendments to the Ontario PPSA

Section 1

In subsection (1), in the definition of "purchase-money security interest", add the following to the end of the existing definition:

, and if the collateral is inventory, subsections (5) and (6) apply;

Add new subsections (5), (6) and (7) as follows:

(5) A purchase-money security interest in inventory:

(a) secures any obligation arising out of a related transaction creating an interest referred to in clauses (a) or (b) of the definition of "purchase-money security interest" in subsection (1); and

(b) extends to other inventory in which the secured party holds or held a security interest under a related transaction that secures or secured an obligation referred to in clauses (a) or (b) of the definition of "purchase-money security interest" in subsection (1).

(6) For the purpose of subsection (5), a transaction is related to another transaction when the possibility of both transactions is provided for in the first transaction or an agreement between the parties entered into before the first transaction.

(7) A purchase-money security interest does not lose its status because:

(a) the purchase-money collateral also secures an obligation that is not a purchase-money obligation;

(b) collateral that is not subject to a purchase-money security interest also secures the purchase-money obligation; or

(c) the purchase-money obligation has been renewed, refinanced, consolidated or restructured.

Section 33

Add new subsections (4) and (5) as follows:

Refinancing

(4) When refinancing of an obligation referred to in clauses (a) or (b) of the definition of "purchase-money security interest" in subsection 1(1) occurs pursuant to a refinancing agreement between the debtor and a secured party other than the secured party who provided the credit or value referred to in those clauses, and

(a) the original registration relating to the purchase-money security interest securing the obligation is amended to identify the secured party named in the refinancing agreement as a secured party; or

(b) before expiry or discharge of the original registration relating to the security interest, a registration relating to the purchase-money security interest is effected disclosing the secured party named in the refinancing agreement as the secured party, or the security interest is otherwise perfected,

the purchase-money security interest is deemed for priority purposes to have been assigned to the secured party who provided value to the debtor pursuant to the refinancing agreement.

Idem

(5) A purchase-money security interest that is deemed to have been assigned as provided in subsection (4) has the same priority it had immediately prior to the deemed assignment with respect to a competing security interest but, where clause (4)(b) applies, is subordinate to advances made or contracted for by the holder of a perfected competing security interest after expiry or discharge of the original registration relating to the purchase-money security interest and before written notice of the deemed assignment is given to the holder.

Section 72.1 (new)

Add a section as follows:

Allocation of payments

72.1 A payment made by a debtor to a secured party must be applied:

(a) in accordance with any method of application to which the parties agree;

(b) in accordance with any intention of the debtor manifested at or before the time of the payment, if the parties do not agree on a method; or

(c) if neither clause (a) nor clause (b) applies, in the following order:

(i) to obligations that are not secured, in the order in which those obligations were incurred;

(ii) to obligations that are secured, other than those secured by purchase-money security interests, in the order in which those obligations were incurred;

(iii) to obligations that are secured by purchase-money security interests, in the order in which those obligations were incurred.