

THE PERSONAL PROPERTY SECURITIES ACT 2009 (CTH) – WHERE IS THE FRAUD EXCEPTION?

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ABSTRACT

Torrens system legislation promotes the principle of indefeasibility of title by upholding the conclusiveness of the land titles register. Nevertheless, fraud on the part of a registered proprietor is specified by the legislation as an exception to indefeasibility. Courts have also recognised exceptions in the form of in personam claims founded in law or equity. A register is also central to personal property securities legislation (PPS legislation). Priority between competing security interests in personal property is normally dictated by registration. The priority rules are comprehensive which compels the conclusion that any priority dispute between security interests will be decided within the four walls of the statute. Yet PPS legislation does not contain a specific carve out for fraud. The more established Canadian and New Zealand PPS legislation does, however, provide that all rights, duties and obligations arising under the Act must be exercised or discharged in good faith. Canadian case law shows that a person's failure to act in good faith has the potential to alter statutory priorities. Australia's PPS legislation does not have an equivalent good faith requirement. While recognising that commercial certainty is well-served by comprehensive statutory priority rules, this paper demonstrates that Australia's PPS legislation requires a provision enabling statutory priorities to be overridden where justified by fraud or dishonest conduct.

I. THE REGISTER IS EVERYTHING

In the early New Zealand case of *Fels v Knowles*,¹ Edwards J stated, in the context of Torrens systems of land registration in the Australasian colonies:²

The object of the Act was to contain within its four corners a complete system ... The cardinal principle of the statute is that the register is everything, and that, except in cases of actual fraud on the part of the person dealing with the

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1 *Fels v Knowles* [1906] 8 GLR 627 (NZCA).

2 At 635.

registered proprietor such person upon registration of the title under which he takes from the registered proprietor has an indefeasible title against all the world.

This case was decided in the year following the seminal decision of the Privy Council in *Assets Co Ltd v Mere Roihi*,³ which explained the meaning of fraud in the context of the exception to indefeasibility. The Privy Council stated that the sections of the Act:

... appear to their Lordships to show that by fraud in these Acts is meant actual fraud, i.e. dishonesty of some sort; not what is called constructive or equitable fraud, an unfortunate expression and one very apt to mislead, but often used, for want of a better term, to denote transactions having consequences in equity similar to those which flow from fraud.

And further:

In dealing with Colonial titles depending on the system of registration which they have adopted, it is most important that the foregoing principles should be borne in mind, for if they are lost sight of that system will be rendered unworkable.

It is clear that Torrens legislation intended to displace equitable doctrines in the interests of certainty and absolute reliance on the register.⁴ To this end, statutory fraud under the Torrens system must be restricted to dishonesty. Concepts of equitable or constructive fraud were firmly eradicated by specific provisions stating that notice of a pre-existing interest does not impeach the indefeasibility of a registered proprietor. Starke J in *Stuart v Kingston* states:⁵

Under the Act, taking property with actual or constructive notice of some trust is not of itself sufficient reason for imputing fraud. The imputation of fraud, therefore, based upon the application of the doctrines of the Court of Chancery as to notice, cannot any longer be sustained in the case of titles registered under the Act ... [F]raud will no longer be imputed to a proprietor registered under the Act unless some consciously dishonest act can be brought home to him. The imputation of fraud based upon the refinements of the doctrine of notice is gone.

Despite these overt attempts to place restrictions on the exceptions to indefeasibility, courts have also recognised *in personam* exceptions to

³ *Assets Co Ltd v Mere Roihi* [1905] AC 176.

⁴ J G Tooher "Muddying the Torrens Waters with the Chancellor's Foot? *Bahr v Nicolay*" (1993) 1 Australian Property Law Journal 1 at 15.

⁵ *Stuart v Kingston* (1923) 32 CLR 309 at 359.

indefeasibility of title. The Privy Council in *Frazer v Walker*⁶ put forth a qualification that a registered proprietor is not allowed to rely on indefeasibility of title to avoid his or her own obligations. The Privy Council stated:

[T]heir Lordships have accepted the general principle, that registration ... confers upon a registered proprietor a title ... which is immune from adverse claims, other than those specifically excepted. In doing so they wish to make clear that this principle in no way denies the right of a plaintiff to bring against a registered proprietor a claim in personam, founded in law or in equity, for such relief a court acting *in personam* may grant.

The doctrine of indefeasibility, therefore, will not deprive courts of their jurisdiction in law and equity to enforce contracts entered into by registered proprietors or to enforce trusts created by them.⁷ Yet the Privy Council indicated that the operation of the qualification must be confined to situations where it does not conflict with the legislation's provisions which stipulate that, except in the case of fraud, the registered proprietor shall hold land subject only to encumbrances noted on the title.⁸

Commentary over the years identifies the rift between extending the scope of exceptions to indefeasibility (the *in personam* qualification in particular) and the legislation's objective to promote certainty in land transactions by absolute reliance on the register.⁹ One commentator cautions that *in personam* claims must be based on a recognised legal or equitable cause of action otherwise they would "drive a horse and buggy through the Torrens system" so a "vague and amorphous concept such as unconscionability" should not on its own defeat a registered interest.¹⁰ Another commentator

6 *Frazer v Walker* [1967] 1 AC 569 at 585.

7 LL Stevens "The *In personam* Exceptions to the Principle of Indefeasibility" (1969) 1 Auckland University Law Review 29, 30; Tooher, above n 4, at 3.

8 Tooher, above n 4, at 3.

9 Penny Carruthers and Natalie Skead "Confirming Torrens Orthodoxy: The High Court decision in *Cassegrain v Gerard Cassegrain & Co Pty Ltd*" (2015) 24 Australian Property Law Journal 211; Lynden Griggs "Resolving the Debate Surrounding Indefeasibility through the Eyes of the Consumer" (2009) Australian Property Law Journal 260; Kelvin F L Low "The Nature of Torrens Indefeasibility: Understanding the Limits of Personal Equities" (2009) 33 Melbourne University Law Review 205; Tang Hang Wu "Beyond the Torrens Mirror: a Framework of the In Personam Exception to Indefeasibility" (2008) 32 Melbourne University Law Review 672; Tooher, above n 4; Stevens, above n 7; Lynden Griggs "The Tectonic Plate of Equity – establishing a fault line in our Torrens landscape" (2003) 10 Australian Property Law Journal 1; Lynden Griggs "*In personam*, *Garcia v NAB* and the Torrens System – Are They Reconciliable" (2001) 1 Queensland University of Technology Law and Justice Journal 76; Johnathon P Moore "Equity, Restitution and In Personam Claims under the Torrens System" (1998) 72 Australian Law Journal 258; Samantha Hepburn "Concepts of Equity and Indefeasibility in the Torrens System of Land Registration" (1995) Australian Property Law Journal 41 and Peter Butt "Notice and Fraud in the Torrens System: A Comparative Analysis" (1977) Western Australia Law Review 354.

10 Moore, above n 9 at 260.

agrees that *in personam* claims should not be allowed to become a “major inroad to the indefeasibility principle”, yet recognises their usefulness as a “minor qualification to indefeasibility”.¹¹ There seems to be a consensus that circumstances will arise when it is necessary to override the indefeasibility of the register to achieve equity.

Personal property securities legislation (PPS legislation) also features a register. It records security interests in personal property. As with the Torrens system, the policy behind PPS legislation promotes absolute reliance on the register which gives rise to the tension between the integrity of the register and achieving fair results. Unlike Torrens system legislation, PPS legislation does not specify fraud as an exception to the integrity of the register, and the legislation remains in relative infancy, so courts have not recognised anything similar to an *in personam* qualification. As a result, the situations in which the integrity of the register will yield to dishonest behaviour remain unclear.

II. PPS LEGISLATIVE FRAMEWORK

PPS legislation provides a legislative framework for personal property securities. As with the Torrens system that was adopted in New Zealand, the states and territories of Australia and several Canadian provinces and territories, PPS legislation is now in force in New Zealand, Australia and all common law provinces and three federal territories in Canada.¹² Although significant drafting differences exist between the jurisdictions, all the Acts share distinctive features that markedly depart from the traditional common law and equitable rules governing personal property securities that had been inherited by each of these British colonial jurisdictions. These features include priority rules focusing on the time of registration rather than the time of the creation of the security interest, a substance over form approach to the characterisation of security interests, priority rules that apply uniformly to all security interests regardless of form and the rejection of traditional concepts of title as these relate to personal property securities.

The most fundamental feature of PPS legislation, however, is the creation of a register of personal property securities. The effect of registration under PPS legislation differs from the Torrens system. Under the Torrens system, it is said that the act of registration is the means by which title passes.¹³ PPS legislation, however, is purely a notice system. Registration is effected to notify third parties of the existence of a security interest. The act of registering or the failure to register does not affect the underlying property interest which is created consensually between a secured party (usually a creditor) and

11 Stevens, above n 7 at 43.

12 PPS legislation was enacted in Ontario in 1976. Between 1978 and 2001, the remaining nine common law Canadian provinces and three federal territories followed suit. New Zealand’s legislation came into force in 2002 and Australia’s in 2012.

13 *Breskvar v Wall* (1971) 126 CLR 376.

a grantor of the security interest who owes the secured party payment or performance of an obligation. However, the rules operate so that the failure to register can lead to a loss of the secured party's security interest in property when other parties also acquire interests in the same property. Therefore, the act of registration or failure to register affects property rights under both the Torrens system and PPS legislation. The Torrens system recognises that holders of such property rights should not be deprived of them by fraudsters taking advantage of the rules under the statute. Arguably, therefore, PPS legislation should also have a mechanism to protect property interests from similar fraudulent activity.

PPS legislation is not intended to be a complete code, but to be supplemented by the general law. Similar to the Privy Council's finding in *Frazer v Walker* that the *in personam* qualification must be confined to situations where it does not conflict with the provisions of Torrens system legislation,¹⁴ PPS legislation provides that the principles of the common law and equity continue to apply if they are capable of operating concurrently with the legislation (supplementary provision).¹⁵ This suggests that equitable principles can still be applied under the PPS legislation to address fraudulent activity.

The priority rules in PPS legislation are a potential area for fraud. The legislation contains rules to determine priorities between competing security interests or other interests in the same property.¹⁶ Registration plays a pivotal role in this priority regime. The priority rules apply so that a failure to register will cause a secured party to lose the priority it would have enjoyed had it registered. When a secured party loses priority upon such a failure, then another secured party or person will benefit. In some cases this benefit will be a pure windfall to a person not prejudiced by the failure.

The priority rules are comprehensive. The legislation provides for a residual or default priority rule which sets out the priority between security interests if the Act provides no other way of determining priority.¹⁷ The default rule acts as a catch-all for any priority dispute not specifically addressed by another priority rule in the legislation. As a result, the rules in the Act will apply to all priority disputes between security interests governed by the Act. This leaves no room for the application of equitable principles to overrule the application of statutory priorities since the application of the principles would not be capable of operating concurrently with the Act.

Canadian commentators agree that the principles of common law and equity are not available to alter statutory priorities even when they produce

¹⁴ See above n 8.

¹⁵ Personal Property Securities Act 2009 (Cth) s 254(1). For a Canadian example, see The Personal Property Security Act, 1993, SS 1993, c P-6.2, s 65(2).

¹⁶ Personal Property Securities Act 2009 (Cth) ss 55-77.

¹⁷ At s 55. Also see the equivalent in New Zealand, Personal Property Securities Act 1999 s 66 and in Saskatchewan, The Personal Property Security Act, 1993, SS 1993, c P-6.2, s 35.

unfairness or result in a windfall.¹⁸ In the 2014 decision of the British Columbia Court of Appeal, *KBA Canada, Inc v Supreme Graphics Limited*¹⁹, a registration was accidentally discharged from the register. The application of the Act's priority rules led to a loss of priority for one creditor and a windfall for another. Legal proceedings were brought arguing that the supplementary provision enabled the court to apply equitable principles to reverse priorities to protect the plaintiff from an innocent mistake where other parties were not prejudiced. Despite the lack of prejudice, the Court of Appeal disagreed. The Court stated that the supplementary provision cannot be interpreted as providing another method for determining priority between securities interests. The Court of Appeal stated further that it was:

... difficult to conceive of a situation in which principles of common law, equity, or the law merchant will be applicable to a priorities dispute, because the [Act] deals with priorities comprehensively.

The Court concluded that nothing in the supplementary provision justifies the application of equitable principles in preference to the priority rules set out in the Act.

Registration errors like the one made in *KBA Canada* can lead to a loss of priority for the party making the error and a corresponding "statutory advantage" to another party. The policy of PPS legislation supports this result because commercial certainty is furthered by ensuring that third parties can rely on the register.²⁰ To balance the interests of innocent third parties who search the register and a registrant who made an error, the Acts provide that a defect in a registration will render the registration ineffective only if it is seriously misleading.²¹ Therefore, not all errors will render a registration ineffective leading to a loss of priority.

The next question, however, is whether the purpose and the policy of PPS legislation can support a statutory advantage for parties whose conduct is called into question. In the interests of commercial certainty, can a party assume the benefit of the legislation's closed system of priority rules through actions that are fraudulent or dishonest? As referred to above, unlike Torrens system legislation where indefeasibility of the register will cede in certain circumstances where someone dishonestly takes advantage of the rules of the

18 Roderick J Wood "Equity, Unjust Enrichment and PPSA Priorities: *KBA Canada Inc v 3S Printers Inc*" (2012) 53 Canadian Business Law Journal 452. Also see Anthony J Duggan "Hard Cases, Equity and the PPSA" (2001) 34 Canadian Business Law Journal 129 at 144, and Roderick J Wood "Supplementing PPSA Priorities: The Use and Abuse of Common Law and Equitable Principles" (2014-2015) 56 Canadian Business Law Journal 31.

19 *KBA Canada, Inc v Supreme Graphics Limited* [2014] BCCA 117.

20 For a more detailed discussion on judicial treatment of registration errors, see Linda Widdup "Registration errors, priority rules and the policy behind the PPSA: In pursuit of certainty or fairness?" (2016) 44 Australian Business Law Review 175.

21 Additionally, in Australia, a registration will be ineffective due to a defect if the error is of a specific type listed in the legislation. See Personal Property Securities Act 2009 (Cth) s 165.

statute, PPS legislation's priority rules do not have a specific carve out for such dishonest conduct.

III. SCENARIO

The following scenario illustrates a foreseeable example of dishonest conduct:

Joe Bloggs is the managing director and controlling shareholder of JB Enterprises Pty Ltd (Enterprises). Enterprises is the parent company of JB Manufacturing Pty Ltd (Manufacturing) which carries on the business of producing plastic products. Joe Bloggs is also the managing director of Manufacturing. To secure the repayment of an "on-demand" shareholder loan in the amount of \$5 million provided by Enterprises to Manufacturing, Manufacturing signed a security agreement granting to Enterprises a security interest in all of its present and after-acquired property. On behalf of Enterprises, Joe Bloggs registered a financing statement on the register to perfect the security interest.

ABC Co (the Supplier) supplies injection moulding machines used in the manufacture of plastic products. The machines are complex, weigh several tonnes and sell for \$1.5 million each. The Supplier receives a call from Joe Bloggs. The Supplier agrees to sell three machines to Manufacturing on retention of title terms. Manufacturing paid a deposit before delivery and Joe Bloggs, on behalf of Manufacturing, signed the Supplier's general terms and conditions agreeing to pay the balance of the purchase price over two years with title being retained by the Supplier until payment was made in full. The Supplier delivered the machines to Manufacturing's site and completed certain modifications to them to conform to the relevant electric safety code.

The Supplier's retention of title is a security interest under the Act²² and is therefore subject to the priority rules in the legislation. However, the Supplier fails to comply with the legislation and protect its priority by registering a financing statement to perfect the security interest. Even though the Supplier still has title to the machines, Enterprises' security interest in all present and after-acquired property automatically attaches to the machines once Manufacturing acquires possession of the machines.²³ The Act operates so that Enterprises' perfected security interest takes priority over the Supplier's unperfected security interest.²⁴ However, if the Supplier had registered within 15 business days of Manufacturing acquiring possession of the machines, the

²² The Supplier's retention of title is an interest in personal property that secures payment of the purchase price so it falls within the definition of security interest in Personal Property Securities Act 2009 (Cth) s 12. Also, see Personal Property Securities Act 2009 (Cth) s 12(2)(d).

²³ At ss 18(3) and 19(5).

²⁴ At s 55(3).

Supplier could have ensured its priority over the machines despite the fact that Enterprises had registered first.²⁵

Joe Bloggs searched the register against Manufacturing's name and, as he hoped and half-expected, noted that the Supplier failed to register its security interest in the machines on the register. On behalf of Enterprises, Joe Bloggs demanded the shareholder loan from Manufacturing and caused Manufacturing to default under the loan by failing to repay the loan on demand. Joe Bloggs then caused Enterprises to appoint a receiver over the assets of Manufacturing.

The Supplier was notified that a receiver had been appointed over the assets of Manufacturing, and requested that the receiver return the machines. The receiver advised the Supplier that due to the Supplier's failure to register its security interest on the register, Enterprises had priority over the machines. The receiver explained that Enterprises registered a security interest in all present and after-acquired property which included the machines, and that the priority rules under the Act provided that Enterprises is entitled to the machines because it registered and the Supplier did not.

The Supplier brought an action to reclaim the machines on the basis that Joe Bloggs, as the directing mind of Enterprises, had acted unconscionably by demanding the loan, appointing receivers and causing a priority dispute to arise between the Supplier's unperfected security interest and Enterprises' perfected security interest. The Supplier argued that Enterprises took advantage of the Act's priority rules and took these steps to acquire the machines on behalf of its subsidiary company without paying for them.

The Court, however, found that the priority rules under the Act were comprehensive and that equitable principles could not be applied because they were incapable of operating concurrently with the priority rules in the Act.²⁶ The Court referred to the British Columbia Court of Appeal decision in *KBA Canada*, which found it was "difficult to conceive of a situation" in which principles of equity will be applicable to a priorities dispute under the Act. Commercial certainty and the integrity of the register were paramount. To this end, there is nothing in the priority rules that prevents Enterprises

25 At s 62(3). The default priority rule in s 55 states that priority between two security interests perfected by registration is determined by the first to register. This suggests that Enterprises would still have priority even if the Supplier had registered within 15 business days of Manufacturing acquiring possession of the machines because Enterprises registered first. However, s 62 provides a more specific rule that overrides the default rule. Section 62 deals with "purchase money security interests" and would apply to give the Supplier priority if the Supplier had registered within the 15 business days. The Supplier has a "purchase money security interest" (defined in s 14) in the form of its retention of title which is given what is often referred to as a "super-priority". However, the Supplier cannot acquire this priority without registering.

26 Personal Property Securities Act 2009 (Cth) s 254.

from taking the benefit of the statutory advantage despite having knowledge that Supplier had a security interest in the machines.²⁷

The Court even referred to Canadian commentary on the PPS legislation, which stated that the courts should not allow equitable concepts to alter statutory priority rules and that there “is room for disagreement over when such doctrines cross the line from supplementing the [Act], which is permissible, to being inconsistent with express provisions, which is not.”²⁸ The Court also supported its reasoning with this quote referred to in the commentary:²⁹

Better to leave an occasional widow penniless by the harsh application of the law than to disrupt thousands of other transactions by injecting uncertainty and by encouraging swarms of potential litigants and their lawyers to challenge what would otherwise be clear and fair rules ... The courts should not believe that they serve society by taking in pitiful strays such as good faith, estoppel, and the equitable lien ...

As a result of the pure application of the priority rules, Enterprises, the parent company of Manufacturing, acquired the machines free and clear of the Supplier’s security interest. A pure windfall for Enterprises.

The difference between the above scenario and the situation in the *KBA Canada* case was that the British Columbia Court of Appeal in that case was dealing with a registration error in the absence of any dishonest or unconscionable behaviour on the part of an arms-length party receiving the statutory advantage or windfall. The above scenario describes a foreseeable situation,³⁰ where a related party took advantage of the priority rules of the Act to acquire property for the benefit of its corporate group at the expense of a supplier. This type of conduct cries out for an exception to the priority rules under the Act. PPS legislation needs a mechanism to address this type of behaviour. While statutory advantages may be acceptable to promote certainty

- 27 Personal Property Securities Act 2009 (Cth) ss 298–9 provide that, if it is necessary to establish that a body corporate has actual or constructive knowledge of particular circumstances, then Enterprises would be attributed with knowledge of Supplier’s security interest. However, with respect to the priority rules that apply to this situation, it is not necessary to establish knowledge. These priority rules are intended to operate despite the fact that a party to the dispute may have knowledge of the existence of a competing security interest.
- 28 John J Chapman “Mistake, Sharp Practice, Equity and the PPSA” (1999) 78 Canadian Bar Review 71.
- 29 James J White and Robert S Summers *Uniform Commercial Code* (4th ed, West Publishing, Eagan, 1995) 377.
- 30 The facts are similar to the facts in the Ontario Court of Appeal decision in *994814 Ontario Inc v RSL Canada Inc* (2006) 20 CBR (5th) 163. In that case, the supplier failed to perfect its security interest, but the Court found for the supplier on the basis that even though the machines had been delivered, the modifications to comply with the electrical safety code had not been completed when the receiver was appointed. The Court found, therefore, that the sale had not taken place and the security interest had yet to arise leaving the supplier able to reclaim the machines. In the scenario above, the modifications were completed prior to the appointment of the receiver.

and predictability in situations in which a party's conduct is not called into question, it is doubtful that the purposes and policy of PPS legislation are promoted if statutory advantages are permitted despite dishonest conduct.

IV. A GOOD FAITH STANDARD

The Canadian and New Zealand Acts have such a mechanism. Most of the Canadian Acts require that "all rights, duties and obligations arising under a security agreement, the Act or any other applicable law" be "exercised or discharged in good faith and in a commercially reasonable manner."³¹ New Zealand's Act also contains a good faith standard requiring "all rights, duties, or obligations that arise under a security agreement or this Act" to be "exercised or discharged in good faith and in accordance with reasonable standards of commercial practice".³² Canadian courts have had occasion to consider situations where a secured party's conduct has given rise to claims that the secured party is not entitled to take advantage of a priority rule. Since common law and equitable principles cannot be used to alter statutory priorities, Canadian courts have resorted to this "good faith" provision to consider whether in appropriate circumstances the Act's priority rules can be altered on the basis that the secured party's conduct breached the general standard of good faith conduct.

This general standard of good faith conduct is notably absent from Australia's Act which requires only that "all rights, duties and obligations" that arise under the *enforcement chapter* of the Act be exercised "honestly and in a commercially reasonable manner".³³ Since this provision applies only to the enforcement of a security interest, it is not available for Australian courts to consider as a means to alter statutory priorities.

V. WHAT IS "GOOD FAITH" IN THE CONTEXT OF PPS LEGISLATION?

"Good faith" is not defined in the Canadian or New Zealand Acts. Canadian commentators provide:³⁴

Comparative guidance on the meaning of the good faith aspect of the standard may be sought in UCC Article 9,³⁵ which defines good faith to mean "honesty in fact". In

31 See, for example, The Personal Property Security Act, 1993, SS 1993, c P-6.2, s 65(3).

32 Personal Property Securities Act 1999 s 25(1).

33 Personal Property Securities Act 2009 (Cth) s 111(1).

34 See Ronald CC Cuming, Catherine Walsh and Roderick J Wood *Personal Property Security Law* (2nd ed, Irwin Law Inc, Toronto, 2012) at 53.

35 The General Provisions in Article 1 of the UCC defined good faith to mean "honesty in fact and the observance of reasonable commercial standards of fair dealing" UCC s 1-201.

other words, the question is whether the particular person acted with a subjective honest intent in the particular circumstances.

These commentators state further:³⁶

The [Act] imposes an overarching obligation on all parties to act in good faith and in a commercially reasonable manner in the exercise of their rights, duties, and obligations under the security agreement, the Act, and any other applicable legislation. The pervasive nature of this duty means that it must be kept in mind in interpreting every provision of the Act that deals with the rights and obligations of any person.

The good faith standard of conduct, therefore, applies not only to conduct between secured party and grantor, but also between competing secured creditors when their disputes are governed by the priority rules in the Act. Under Article 9, the standard has been applied to permit a lack of good faith to alter priorities between secured parties which otherwise would be determined by statutory rules in Article 9.³⁷ The case law discussed below illustrates that this application of the standard has been accepted under Canadian PPS legislation as well.

VI. SOME “GOOD FAITH” CASE LAW

Case law relating to the good faith standard between competing secured parties focuses on knowledge and the effect of one party taking a security interest and claiming priority despite having prior knowledge of an existing security interest of the other party.³⁸ Importantly, the Canadian³⁹ and New Zealand⁴⁰ Acts specifically provide that a person does not act in bad faith merely because the person acts with knowledge of the interest of some other person. Similar to the Torrens system legislation discussed above, the equitable doctrine of constructive fraud has no place within PPS legislation. As a result, something more than knowledge is required and the cases generally focus on whether any particular conduct in addition to knowledge amounts to bad faith. The cases reveal that imposing a good faith standard is necessary to address certain conduct that can arise in the context of the priority rules in

³⁶ Ronald CC Cuming, Catherine Walsh and Roderick J Wood *Personal Property Security Law* (2nd ed, Irwin Law Inc, Toronto, 2012) at 52.

³⁷ Russell A Eisenberg “Good Faith under the Uniform Commercial Code – A New Look at an Old Problem” (1971) 54 *Marquette Law Review* 1 quoting *Thompson v United States* 408 R 2d 1075,1084 (8th Cir 1969), 6 UCC Rep 20.

³⁸ The priority rules generally apply despite knowledge. See above n 27.

³⁹ See, for example, The Personal Property Security Act, 1993, SS 1993, c P-6.2, s 65(4).

⁴⁰ Personal Property Securities Act 1999 s 25(2).

the Act. The cases also reveal that the courts have appropriately applied the good faith standard so as not to “drive a horse and buggy through”⁴¹ the goals of commercial certainty and the integrity of the register.

A. Carson Restaurants International Ltd v A-1 United Restaurant Supply Ltd⁴²

In this case, Dennis Skuter was the controlling shareholder of both Carson Restaurants International Ltd and Yorkton Restaurant & Deli Ltd. Carson and Yorkton entered into a franchise agreement pursuant to which Yorkton granted to Carson a security interest in all of its present and after-acquired property to secure development expenses incurred by Carson on behalf of Yorkton. A year later, A-1 United Restaurant Supply Ltd provided to Yorkton on credit various items of restaurant equipment and, on behalf of Yorkton, Skuter signed a security agreement granting to A-1 a purchase money security interest in the equipment.⁴³ Carson’s security interest also attached to the equipment as after-acquired property. At this point, neither Carson nor A-1 had perfected its security interest by registering a financing statement against Yorkton.

Yorkton failed to make payment to A-1 causing A-1 to demand payment from Skuter who assured A-1 that the debt would be repaid. At this point, A-1 registered a financing statement to perfect its security interest, but registered incorrectly against the wrong debtor name, which means that the registration is ineffective because it contains a seriously misleading error.⁴⁴ A few months later, Skuter obtained a search against Yorkton’s correct name which failed to disclose A-1’s financing statement, thus establishing that A-1’s registration was seriously misleading and ineffective. A few days after this, Skuter caused Carson to register a financing statement against Yorkton, presumably to perfect the general security interest arising under the franchise agreement, which now included the equipment financed by A-1. Since A-1’s financing statement contained a seriously misleading error rendering it ineffective, A-1’s security interest was unperfected. Carson’s registration gave it a perfected security interest so Carson acquired priority over the equipment.

A few months later, Yorkton defaulted under the franchise agreement and Carson seized all of the assets of Yorkton. Shortly after the seizure, Carson

41 See Moore, above n 9.

42 *Carson Restaurants International Ltd v A-1 United Restaurant Supply Ltd* [1989] 1 WWR 267 (Saskatchewan Court of Queen’s Bench). See Cuming, Walsh and Wood, above n 34, at 486, where the authors state that this is the leading Canadian case on the interpretation of good faith.

43 The priority rules apply so that A-1’s purchase money security interest would have priority over Carson’s security interest in all present and after-acquired property, but only if A-1 had registered within the time frames dictated by the legislation. See above n 25.

44 The registration of a financing statement is invalid if it contains a seriously misleading defect, irregularity, omission or error, The Personal Property Security Act, 1993, SS 1993, c P-6.2, s 43(6). Australia’s PPS legislation contains a similar rule in s 164.

notified A-1 of its intention to retain the equipment in satisfaction of Yorkton's debts under the franchise agreement.⁴⁵ A-1 served a notice of objection to Carson's proposed retention and sought an order declaring that it had a prior valid security interest.

While recognising that the Act applied to give Carson priority, the Court found that the facts "cry out for the invocation" of the principles of equity and that "good faith" is "imported into the statutory rights sought to be exercised by a person granting and/or receiving security agreements."⁴⁶ The judge stated:

While I am of the view that ordinarily the court ought to maintain the integrity of the registry system under the Act, circumstances will arise, as here, where the integrity of the system ought to be subrogated to prevent an unjust result.

The Court found that Skuter was the only person who could have acted upon Yorkton's default and cause the seizure of the assets and would not permit Carson to take advantage of A-1 by using 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" upon Yorkton's default.⁴⁷ While mere knowledge of the unperfected interest of A-1 does not constitute bad faith, the threshold was breached when Skuter assured A-1 that Yorkton's debts would be paid, but then caused Carson to act upon Yorkton's default to seize collateral financed by A-1.

The facts of this case justify altering the priority rules. Skuter controlled two companies, each of which was in the restaurant business and had use for the equipment financed by A-1. Skuter attempted to use the rules of the Act to retain the equipment without having either company pay for it. Without a good faith standard imposed by the statute, the Court would be constrained by the comprehensive nature of the Act's priority rules and would not be able to find in favour of A-1.

B. Strathcona Brewing Co v Eldee Investment Corp⁴⁸

Eldee Investment Corp perfected a security interest in the assets of Strathcona Brewing Co. Mr and Mrs Chappell subsequently agreed to loan additional moneys to Strathcona and take security over its assets. They forwarded funds to their solicitor on the trust condition that Eldee's security

45 After default, a secured party is entitled to retain the collateral in satisfaction of the obligation secured as an alternative to selling the collateral provided that the secured party gives notice and does not receive a notice of objection, The Personal Property Security Act, 1993, SS 1993, c P-6.2, s 61(1).

46 The Personal Property Security Act, 1993, SS 1993, c P-6.2, s 65(3).

47 Although fraud had not been alleged against Skuter, the Court also emphasised the holding in the House of Lords decision in *McCormick v Grogan* (1869) LR 4 HL 82 that the Court of Equity decided that even an Act of Parliament shall not be used as an instrument of fraud.

48 *Strathcona Brewing Co v Eldee Investment Corp* (1994) 17 Alta LR (3d) 405.

interest be discharged. The solicitor, who was also Eldee's solicitor in its Strathcona transaction, discharged Eldee's registration without receiving Eldee's instructions nor informing Eldee about the discharge. Eldee's security interest, therefore, became unperfected. Upon Strathcona's insolvency, the Chappells' asserted priority over the assets of Strathcona on the basis that their perfected security interest had priority over Eldee's unperfected security interest. Eldee argued that, despite the fact that its security interest was no longer perfected, its security interest should be reinstated with its previous priority position because the Chappells knew when they took their security interest that Eldee had a prior security interest.

The Court recognised that the legislation specifically provides that a person does not breach the standard of good faith merely because that person acts with knowledge of the interest of some other person. Despite the fact that the solicitor negligently caused Eldee's loss, there was no evidence that the Chappells acted in bad faith, so subordinating their security interest and reinstating Eldee's priority position was not warranted. This case can be distinguished from the *Carson* case because the Chappells did not actively mislead Eldee, the competing secured party.

Although the result is unfair on Eldee, the Court squarely addressed the rules and policy of the Act. This was not an appropriate case to alter the priority rules since the conduct leading to the unfairness was that of the solicitor not the secured party. Eldee's remedy should not be found within the Act, but in an action in negligence against the solicitor for improperly discharging Eldee's registration. The Court declined to invoke other principles of equity because to do so would be inconsistent with the express rules of the Act. Not only would any equitable relief be inconsistent with the first-to-register priority rule, the Act has a specific rule providing recourse for registrations that have been fraudulently or mistakenly discharged.⁴⁹ The initial priority can be reinstated if the secured party re-registers within 30 days of the date the original registration was discharged. Eldee failed to avail itself of the protection of this section and, as a result, the Chappells retained priority. The fact that Eldee was not notified of the discharge because the financing statement registered by the solicitor listed the solicitor's address rather than Eldee's address was not material.

C. Canadian Imperial Bank of Commerce v AK Construction (1988) Ltd⁵⁰

Both Canadian Imperial Bank of Commerce (CIBC) and RoyNat Inc were secured lenders of AK Construction. When they first started dealing with AK Construction, CIBC's security was limited to accounts receivable while RoyNat's security extended to all assets. RoyNat signed a priority

49 Personal Property Security Act, RSA 2000, c P-7, s 35(8).

50 *Canadian Imperial Bank of Commerce v AK Construction (1988) Ltd* [1995] 8 WWR 120 (Alberta Court of Queen's Bench).

agreement agreeing to postpone its security but in “accounts receivable only”, thus enabling CIBC to acquire priority to the accounts receivable. Several years later, CIBC extended its security beyond accounts receivable when AK Construction granted to CIBC a security interest in all of its present and after-acquired property. As a result, when AK Construction became insolvent, each of CIBC and RoyNat had a security interest in all of AK Construction’s property. The evidence suggested that, at the time AK Construction began experiencing financial difficulty, CIBC understood that RoyNat had priority over all assets other than accounts receivable. CIBC also knew that the accounts receivable to which it had priority were not sufficient to satisfy CIBC’s loan.

At issue were several pieces of heavy construction equipment. Both lenders had security over the equipment, but neither had registered against the serial numbers of the equipment, which is required in order to perfect the security interests in the equipment.⁵¹ On the eve of AK Construction’s insolvency, CIBC proceeded to register against the serial numbers. The priority rules, therefore, operated to give CIBC priority over the equipment. RoyNat argued that CIBC acted in bad faith. RoyNat submitted that both parties understood that CIBC had priority over accounts receivable and RoyNat had priority over everything else including the equipment, and that by making these registrations against the serial numbers, CIBC repudiated a course of conduct that RoyNat relied on since the priority agreement was signed. As a result, CIBC should not be able to rely on the Act’s priority rules.

The Court, however, focused on the fact that the Act provides that a person does not act in bad faith merely because the person acts with knowledge of the interest of some other person. The Court held that some additional positive action is required that could “constitute a waiver or support an estoppel argument or actively mislead or hinder the perfection of the prior interest”. In this case, the fact that CIBC knew that RoyNat had security that it could have registered by serial number is insufficient to constitute bad faith. CIBC “saw an opportunity for registration, and they took it.” A course of conduct could not be relied upon because the alleged conduct occurred prior to CIBC acquiring its security interest in the equipment with the knowledge that RoyNat had a prior security interest in that equipment. The Court’s reasoning is consistent with the policy of the Act. Even though RoyNat’s reliance argument may seem compelling, RoyNat could have protected its priority position by registering against the serial numbers of the equipment. CIBC did nothing to hinder RoyNat from doing so.

51 Personal Property Security Act, RSA 2000, c P-7, s 35(4).

*D. The Bank of Nova Scotia v Royal Bank of Canada*⁵²

The Royal Bank of Canada perfected a security interest in Mr Le's truck. Unbeknownst to Royal, Le transferred the truck to Mr Burd, who had obtained financing from the Bank of Nova Scotia (BNS) to purchase the truck. Despite the transfer to Mr Burd, the rules in the Act apply, so that Royal's perfected security interest continues in the truck. BNS performed a search of the register against the truck using an incorrect serial number which did not disclose Royal's security interest. BNS provided the financing to Burd and perfected its own security interest in the truck. BNS subsequently discovered Royal's prior perfected security interest. The priority rules provide that Royal would have priority over BNS because Royal was the first to register its security interest.

When Le defaulted on his loan, Royal attempted to seize the truck but was unable to locate it. A search of the register disclosed BNS's security interest. Royal advised BNS that it was in a position to seize the truck, but offered to settle the matter to avoid upsetting BNS's customer, Mr Burd. BNS's account officer told Royal that she would seek instructions from her superiors to pay out Royal. On the basis of this information, Royal took no further steps to seize the truck and waited for a response from BNS.

Section 51 of the British Columbia Act provides that if Royal fails either to take possession of the truck or register against Burd (the transferee of the truck from Royal's customer Le) within 15 days of learning about the transfer, it will lose priority to a security interest perfected after the expiry of the 15 day period. Royal learned about the transfer when it conducted the search of the register immediately prior to contacting BNS. While Royal was waiting for BNS to respond with a payout offer, the 15 days expired, leaving Royal vulnerable to subsequent security interests. After receiving legal advice in relation to s 51, BNS thought it could take advantage of this provision and so, after 15 days expired from its call with Royal, registered a second financing statement essentially to perfect its already-perfected security interest in an attempt to bring BNS within the ambit of s 51 and take priority over Royal. Meanwhile, Royal held off seizing the vehicle while waiting for BNS to respond to its offer.

Royal argued that the equities were in its favour. BNS made an initial error in using the wrong serial number to search. Further, Royal held off perfecting its position by seizing the truck because it was attempting to negotiate a settlement with BNS. BNS attempted to rely on a narrow technical interpretation of s 51 to circumvent the legislative intent which is to protect subsequent secured parties not existing secured parties. BNS argued that its claim is based solely on the wording of the Act which is a code that provides rules that must be followed to preserve the integrity and usefulness of the registry. BNS admitted to taking advantage of those rules by taking the steps

52 *The Bank of Nova Scotia v Royal Bank of Canada* (1998) 14 PPSAC (2d) 10 (British Columbia Supreme Court).

the rules specifically provide, but denies that it acted in bad faith. The Court was required to balance the equities against the strict rules of the statute.

The Court found that BNS did not act in good faith as required by the Act.⁵³ Although the Act states that a person does not act in bad faith merely because the person acts with knowledge of the interest of another person, BNS acted while in discussions with Royal about settling the matter without seizing the truck. The clear implication from the discussions between the Royal and BNS account managers was that Royal would not seize the truck while waiting to hear from BNS. The Court applied the principles emerging from the *Carson* case and found that BNS used the Act as an instrument to defeat Royal's claim and that the integrity of the system ought to be subjugated to prevent an unjust result.

This case appears to have similar facts to the *AK Construction* case (discussed above), in which the Court held that CIBC did not act in bad faith when registering against the serial numbers to assert priority over RoyNat where RoyNat alleged that CIBC repudiated a course of conduct relied upon by RoyNat. However, in that case, CIBC took no positive action to inhibit RoyNat from itself registering against the serial numbers. In this case, however, BNS knew that Royal was intending to seize the vehicle and actively misled Royal when it stated that it was interested in settling the matter. This act inhibited Royal from seizing the vehicle and thereby protecting its priority position.

VII. CONCLUSION

The case law emerging from the application of the general standard of good faith under Canadian PPS legislation illustrates that factual situations do arise where the conduct of the parties warrants altering statutory priorities. Without a good faith requirement, no basis exists under PPS legislation to override the express statutory priority rules in circumstances where bad faith conduct of a secured party enables the secured party to benefit from the priority rules at the expense of a competing party. Even though PPS legislation envisages a continuing role for equity, equitable principles cannot be employed to alter the priority rules of the Act. This is not the case with a general standard of good faith conduct which can be applied under the Act to alter statutory priority rules. The case law also reveals that courts can be relied upon to balance competently the good faith requirement with the principles and policies of the Act which promote commercial certainty and the integrity of the registry system.

53 The Court held firstly that it was not convinced that, by registering a second financing statement, BNS had brought itself within s 51 because s 51 was not designed to protect pre-existing secured parties and BNS' subordinate position was not affected by Royal's failure to comply with s 51. However, in case it was wrong on this point, the Court also dealt with the good faith issue.

It is submitted that Australia's Act should include a general standard of good faith conduct similar to its counterparts in Canada and New Zealand. In returning to the scenario set forth above, the Supplier could argue that Enterprises breached the standard of good faith. Enterprises would not breach the standard of good faith simply because it knew of the Supplier's unperfected security interest. However, if the rulings of the Canadian courts are applied to this situation, Enterprises breached the standard of good faith in demanding the loan from Manufacturing, causing Manufacturing to fail to repay the loan and appointing a receiver to claim priority for Enterprises who happens to be Manufacturing's parent company. If Australian courts took the same approach as the Canadian courts to the application of good faith in situations where a party dishonestly takes advantage of the priority rules, a good faith provision would not "drive a horse and buggy through"⁵⁴ the personal property securities legislative framework.

54 See Moore, above n 9.