The Concept of a Security Interest: The Canadian Experience

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1. Introduction

The enactment of the *Personal Property Securities Act 2009* (Cth) ("PPSA")[1] brings into play a series of fundamental changes to secured transactions law in Australia. Perhaps the most significant of these changes is the adoption of a unitary concept of a security interest. This represents a radical departure from the past in which several different species and subspecies of security interests[2] and quasi-security interests[3] co-existed. The PPSA draws heavily from personal property security legislation in Canada[4] and the United States.[5] The architects of these systems recognized that although there were a variety of different types of security devices governed by their own separate rules, they shared a common feature. They were designed to secure payment or performance of an obligation. The critical move was to recognize that they should be assimilated and governed by the same set of principles. The unitary concept of a security interest was the lynchpin that made it possible to implement many of the other fundamental changes to personal property security law.[6]

The recognition of a unitary concept of a security interest did not simply mean that the various consensual security interests and quasi-security interests – the pledge, contractual lien, mortgage,

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[1] Unless otherwise provided, references to the PPSA are to the Australian legislation.

[2] The traditional forms of non-consensual security were the pledge, contractual lien, mortgage and charge. See Beale, Bridge, Gullifer & Lomnicka, *The Law of Personal Property Security* (Oxford: OUP, 2007) at 8.

[3] Quasi-security interests are usually created by retention of title and include conditional sales agreements, hire purchase agreements and finance leases. See *ibid.*, at 9-10.

[4] Each province and territory in Canada has enacted a PPSA, with the exception of the civil law jurisdiction of Quebec, which has adopted a hybrid of civil law and PPSA inspired concepts. There are two basic models in use – the model adopted in Ontario and the model in use in the other common law provinces. Although there is little prospect of a uniform statute in the foreseeable future, there are currently some efforts to achieve a convergence on matters where the two models differ. See R.C.C. Cuming, C. Walsh & R. Wood, "Secured Transactions Law in Canada – Significant Achievements, Unfinished Business and Ongoing Challenges" (2011), 50 C.B.L.J. 156 at 174-78.

[5] Uniform Commercial Code, Article 9.

[6] These include the creation of a single unified registry system, a comprehensive set of priority rules based upon the time of registration, a single set of enforcement rules that provide remedies on default.

charge, conditional sales, hire purchase and finance lease – were to be husbanded together for the purposes of the registration, priorities and enforcement regime of the PPSA, but would retain their separate character and identity for other purposes. In Canada, courts at the highest level have recognized that the transformation has been more profound. The concept of a unitary security interest is not one that applies only within the context of the PPSA; the juridical nature of a security interest has been pervasively altered. The old dichotomies that characterized security interests as fixed or floating, legal or equitable were swept away, as was the division between true security interests and quasi-security interests.

2. A Brief History

Canadian, New Zealand and Australian personal property security legislation all share a similar structure and methodology with Article 9 of the Uniform Commercial Code of the United States.[7] The drafters of Article 9 set out to reform secured transactions law through the adoption of a unitary concept of a security interest. This represented a fundamental break with the past. Grant Gilmore, one of the principal architects of Article 9, recounts that:[8]

> The idea which the draftsmen started with was that the system of independent security interests had served its time; that the formal differences which separated one device from another should be scrapped and replaced with the simple concept of a security interest in personal property; that all types of personal property, whether held for use of sale, should be available for security.

The adoption of a unitary concept of a security interest has a number of different consequences. First and foremost, it means that the former differences among the various types of financing devices no longer have any significance. The distinct legal rules and principles that pertained to the pledge, the mortgage, the floating charge, and the assignment of receivables no longer have

[7] For a discussion of some of the background to the reform efforts in Australia and New Zealand, see A. Duggan & M. Gedye, "Personal Property Security Law Reform in Australia and New Zealand: The Impetus for Change" (2009), 27 Penn State International Law Review 655.
[8] Grant Gilmore, *Security Interests in Personal Property*, vol. 1, (Boston: Little, Brown & Co:, 1965) at 290.

any role to play. In their place, there is a single concept and a single source of law that governs security interests in personal property.[9]

A second aspect of this unification and reform of secured transactions law is that transactions that were not technically regarded as secured transactions were brought within the scope of the legislation. Historically, the pledge, lien, mortgage and charge were transactions by way of security – transactions by which the debtor created an interest in the debtor's assets in order to secure payment or performance of an obligation. Conditional sales contracts and other title retention devices did not qualify, since the debtor did not obtain title to the property in question until the full purchase price and credit charges had been satisfied. Nevertheless, they served a like function and were often characterized as "quasi-security." These devices were also brought within the scope of the Act.[10] They should no longer be considered quasi-security interests as they create security interests with exactly the same nature and characteristics as any other security interest governed by the Act.

The PPSA concept of a security interest entails a second idea that is closely associated with the unitary concept of a security interest. It is the idea that the definition of a security interest covers any transaction that in substance creates a security interest, regardless of its formal attributes or the identity of the person who holds title to the property.[11] This is sometimes referred to as the "substance" test. Not only does the definition cover the traditional types of security interests, it will also cover any new financing devices that are created if they are designed to secure payment or performance of an obligation.

This, too, is a radical departure from the past. The pre-reform law adopted a formal approach which drew distinctions on the basis of the legal category of interest that was created. Indeed, this contributed to the proliferation of independent security devices. The parties were able to develop new types of financing devices, and often did so in order to evade registration or other onerous requirements. The PPSA does not permit the creation of new forms of security devices that fall outside the scope of the Act. The PPSA "is all-embracing, all devouring; it covers

[9] PPSA, s.12(1).
[10] PPSA, s.12(2).
[11] PPSA, s.12(1).

everything."[12] New financing devices can be created, but they will be governed by the PPSA if their function is to secure payment or performance of an obligation. In determining if a transaction in substance secures payment or performance of an obligation, one must look at the economic effect of the transaction rather than its legal form. The test therefore captures disguised security interests – transactions that take the form of a non-security transaction but which have the effect of securing payment or performance of an obligation.[13] Transactions such as leases and consignments are therefore brought within the definition if the economic reality is that they operate to secure an obligation.

This paper will examine the Canadian experience with these two foundational concepts. The courts have, with one exception, given full reign to these concepts, and have recognized that they have fundamentally altered the structure of secured transactions law.

3. The Unitary Concept of a Security Interest

The adoption of a unitary concept has meant that the old forms of security interests no longer hold any special significance. Each can be used to create a security interest, but the nature and characteristics of the security interest is the same regardless of its form. There were several false starts in Canada in the early years when some courts instinctively clung to the old terminology and concepts and tried to replicate them within the context of the PPSA. For example, courts attempted to recreate the idea of crystallization of a floating charge by manipulating the PPSA concept of attachment. The courts have since rejected this approach, and have recognized that the PPSA has completely transformed the nature of some pre-PPSA devices such as the floating charge. The courts have been somewhat less successful with a similar transformation of the conditional sales agreement. This problem often arises when other statutes continue to use of the older terminology and concepts, and it has, on occasion, caused courts to depart from the notion of a unitary security interest.

[12] Gilmore, *supra* note 8 at 295.
[13] See R.C.C. Cuming, C. Walsh & R.J. Wood, *Personal Property Security Law* (Toronto: Irwin Law, 2005) at 67-80.

a) The Transformation of the Floating Charge

The juridical nature of the floating charge is a topic that has attracted much attention and debate.[14] The charge is said to be an existing but non-specific charge on the debtor's assets that permits the debtor to deal with those assets.[15] Upon crystallization, the charge specifically attaches to the individual assets and the debtor no longer has the ability to deal with them.[16] In Australia, there is greater support for the view that a floating charge did not give rise to any proprietary interest until its crystallization.[17]

The unitary concept of a security interest under the PPSA does not allow for the idea of a present but non-specific charge. Nor does it allow for the idea of a present but non-proprietary security right. A security agreement that purports to create a floating charge creates a security interest and is governed by the same rules that govern any other security interest. Canadian cases have worked out the consequences of this reconceptualization of the floating charge.

i) Time of Attachment

Although the floating charge was abolished as an autonomous legal concept under the PPSA, this did not mean that floating charge debentures or security agreements that created floating charges could no longer be used. These agreements clearly manifest an intention to create a security interest. But the security interest that is created is no different from any other security interest. The rules that govern when the interest arises (attachment of the security interest) and the rules governing its priority are no different from those that govern agreements in the form of a pledge, mortgage, charge or title retention device, or newer agreements that simply grant a security interest in the collateral.

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[14] L. Gullifer & J. Payne, "The Characterization of Fixed and Floating Charges" in J. Getzler & J. Payne (eds.) *Company Charges: Spectrum and Beyond* (Oxford: OUP, 2006) 64; P. Watts, "Alternative Types of Charge over Co Businesses and the Effect of Winding up on Them – Recent Developments in Australia and New Zealand" (1989) 12 U.N.S.W.L.J. 179; S. Worthington, *Proprietary Interests in Commercial Transactions* (Oxford,: Clarendon Press, 2006) at 74-77; R. Nolan, "Property in a Fund" (2004), 120 L.Q.R. 108.

[15] *Evans v. Rival Granite Quarries Ltd.*, [1910] 2 K.B. 979.

[16] *Ibid.*

[17] W.J. Gough, *Company Charges*, 2nd ed., (London: Butterworths, 1996) at 97-101; D. Everett, *The Nature of Fixed and Floating Charges as Security Devices*, (Monash Law Press, 1988) at 21-26. And see *Tricontinental Corporation Ltd. v. Federal Commissioner of Taxation* (1987), 73 A.L.R. 433; *Lyford v. Commonwealth Bank of Australia* (1995), 17 A.C.S.R. 211.

Despite the adoption in the PPSA of a unitary concept of a security interest, some earlier Canadian decisions attempted to replicate some of the unique features of the floating charge within the context of the PPSA. Some courts took the view that the use of the older floating charge form of agreement showed an intention to delay attachment of the security interest until the charge had crystallized.[18] This line of thinking would have resulted in a partial resurrection of the floating charge and all the complexities associated with the crystallization concept. This approach has withered on the vine. Courts have decisively rejected the idea that the concept of crystallization continues to apply under the PPSA.[19] Later versions of the statute reinforced this position by expressly stating that that the rules for attachment apply to a security interest including a security interest in the nature of a floating charge.[20]

ii) Authorization and the Reigning-In of the Licence Theory

The juridical nature of the floating charge has never been satisfactorily resolved. This search for an underlying theory is no longer useful, as the floating charge has ceased to be an autonomous security device under the PPSA. A PPSA security interest is a fixed security interest that comes into existence when the requirements for attachment of the security interest have been satisfied. This is the case even when the collateral is in the form of circulating assets, such as inventory or accounts. Although the assets are subject to the security interest, the debtor is able to deal with the assets if the secured party has authorized the dealing.[21] There are two consequences of this. First, the debtor is obviously not in breach of the security agreement if the debtor deals with the asset within the authority to deal granted by the secured party. Secondly, the party who acquires the interest in the asset as a result of the dealing takes free of the security interest.[22]

The PPSA does not rely solely upon the authorization idea in protecting parties who deal with the debtor. The secured party may have restricted the debtor's ability to deal with circulating

[18] See, *e.g., Access Advertising Management Inc. v. Servex Computers Inc.* (1993), 15 O.R. (3d) 635 (Gen. Div.).
[19] *G.M. Homes Ltd., Re* (1984), 10 D.L.R. (4th) 439 (Sask. C.A.); *Irving A. Burton Ltd. v. Canadian Imperial Bank of Commerce* (1982), 134 D.L.R. (3d) 369 (Ont. C.A.); *Roynat Inc. v. United Rescue Services Ltd.*, [1982] 3 W.W.R. 512 (Man. C.A.). And see J.S. Ziegel, "Floating Charges and the OPPSA: A Basic Misunderstanding" (1994), 23 C.B.L.J. 470.
[20] PPSA, s.19(4).
[21] PPSA, s.32(1)(a).
[22] See *Lanson v. Saskatchewan Valley Credit Union Ltd.* (1998), 14 P.P.S.A.C. (2d) 71 (Sask. C.A.).

assets from the outset, or the secured party may have withdrawn the authorization upon the occurrence of some event, such as an event of default. The PPSA provides a set of priority rules that protect parties who acquire inventory in the ordinary course of the debtor's business,[23] or who receive payment of their claims.[24] These priority rules operate whether or not the secured party has authorized the transaction.

The PPSA contemplates that the authorization may be express or implied. The possibility remained that courts might use a wide implied authorization idea to breathe new life into the floating charge idea within the context of the PPSA. For example, it might be argued that the use of a floating charge debenture indicates that the grantor was authorized to create a wide range of competing interests in priority to the security interest created by the floating charge debenture. Some courts adopted the view that a secured party who authorizes the sale of inventory impliedly agrees to the subjection of its security interest to other claims that may arise in the ordinary course of business, such as the creation of non-consensual security interests in favour of the Crown in respect of taxes that ought to have collected in connection with the sales.[25]

Although for a time it seemed that this argument had some traction, it was ultimately rejected by the Supreme Court of Canada in *Royal Bank of Canada v. Sparrow Electric*.[26] The Court rejected a wide conception of the authorization (the licence to sell the inventory) and held that "what a security agreement with a licence to sell creates is a defeasible interest; but the event of defeasance is the actual sale of the inventory and the actual application of the proceeds against an obligation to a third party."[27] Many security agreements in use in PPSA jurisdictions give the secured party a security interest in all present and after-acquired personal property, and authorize the sale of inventory in the ordinary course of business and the collection of accounts. This gives buyers and creditors who were paid from the proceeds the accounts priority, but it does not replicate the wide latitude that was given to the debtor to deal with the assets prior to crystallization of a floating charge.

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[23] PPSA, s.46.
[24] PPSA, ss. 48, 59.
[25] See *G.M. Homes, Re*, *supra* note 19. And see R.J. Wood, "Revenue Canada's Deemed Trust Extends its Tentacles: *Royal Bank of Canada v Sparrow Electric Corp."* (1995) 10 B.F.L.R. 429.
[26] [1997] 1 SCR 411.
[27] *Ibid.*, at para. 94.

iii) Permissive Provisions and Subordination

Although secured parties may continue to use older forms of security documents, the security interest that is thereby created does not depend on the form of agreement. The security agreement creates a security interest, and its attributes and priority are governed by the PPSA. There is at least one situation where use of the older forms of agreement may prove to be detrimental. The issue concerns the inclusion of restrictive and permissive provisions in security agreements.

Under the pre-reform law, it was common to include restrictive provisions (often referred to as "negative pledge covenants" in Canada and the United States) that limited the debtor's authority to grant a security interest in the collateral subject to the charge. The restrictive provision was often modified by a permissive provision that carved out certain permitted transactions – typically involving the creation of purchase money security interests.[28]

The controversy arises when the holder of the purchase money security interest fails to register within the time frames necessary to obtain the higher ranking priority afforded by the PPSA over prior registered security interests.[29] As the special priority rule in favour of purchase money security interests is inapplicable, the priority competition will be resolved through the application of the ordinary priority rule with the result that the first party to register will prevail.[30] However, if the holder of the purchase money security interest can show that the earlier secured party agreed to subordinate its security interest, the agreement will be given effect. The PPSA contains an express provision that validates the use of subordination agreements between or among the creditors (inter-creditor agreements) as well as subordination provisions contained in the security agreement between the secured party and the debtor.[31] The holder of the purchase money security interest will therefore argue that the inclusion of a permissive provision in the security agreement amounts to a subordination to a person who enters into a permitted transaction.

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[28] See K. Morlock, "Floating Charges, Negative Pledges, the PPSA and Subordination: *Chiips v. Skyview Hotels Limited*" (1995) 10 B.F.L.R. 405.
[29] PPSA, s.62.
[30] PPSA, s.55.
[31] *Sperry Inc. v. Canadian Imperial Bank of Commerce* (1985), 17 D.L.R. (4th) 236 (Ont. C.A.); *Bank of Nova Scotia v. Royal Bank* (1987), 8 P.P.S.A.C. 17 (Sask. C.A.).

Canadian courts have held that a permissive provision by itself is not sufficient to constitute a subordination provision. A covenant that the debtor shall keep the collateral free of all security interests or encumbrances other than permitted encumbrances does not result in a subordination of the security interest to the permitted encumbrance. Rather, it means that the creation of a permitted encumbrance will not constitute a breach of the contractual provision, which would constitute an event of default and permit the secured party to enforce the security interest. But if the provision goes further and refers to the priority ranking of permitted encumbrances, the provision will constitute a subordination provision.[32]

The distinction is a subtle one. A provision under which the debtor agrees to keep the collateral free of all encumbrances *ranking in priority to or pari passu with the security interest* other than permitted encumbrances subordinates the security interest to the permitted encumbrance. If the italicized wording is removed, the provision merely excepts the transaction from the scope of the negative covenant but does not in itself effect a subordination.

iv) Abandonment of the Floating Charge Debenture

Although Canadian judicial decisions have now confirmed that the use of a floating charge does not produce a different kind of security interest or different priorities, the drafters in the early years following adoption of the PPSA operated under a real apprehension that the use of the floating charge might result in an inferior priority status. As a result, the floating charge form of agreement has been almost completely abandoned in favour of modernized forms of security agreements that adopted PPSA terminology. In its place, drafters produced a "general security agreement" (or "GSA") under which the debtor grants to the secured party as security interest in all of its present and after-acquired personal property. If the security agreement contains a permissive provision, the drafter will generally ensure that the language will not constitute a subordination unless so intended by the parties.

[32] *Asklepeion Restaurants Ltd. v. 791259 Ontario Ltd.* (1996), 11 P.P.S.A.C. (2d) 320 (Ont. Ct. Gen. Div.), aff'd (1998) 13 P.P.S.A.C. (2d) 295 (Ont. C.A.); *Re DCD Industries (1999) Ltd*. (2005), 11 C.B.R. (4th) 246 (Alta. C.A.).

v) Competitions with non-PPSA Interests

Although the PPSA contains a set of priority rules that govern many kinds competitions that can arise, these rules are not exhaustive. There are simply too many different types of proprietary rights, and it is simply not realistic to expect that the statute can provide a specific rule for every possible priority competition. The matter therefore falls to be determined through the application of ordinary property law principles. At this juncture, a critical issue arises. How is a PPSA security interest to be characterized? Do we revert to the older categories (pledge, mortgage, charge, title retention) and characteristics (fixed v. floating) when the PPSA does not provide a specific priority rule. Or do we regard the PPSA as having a more pervasive effect such that the old categories are banished throughout the realm?

The Supreme Court of Canada has ruled unequivocally in favour of the latter approach in *Bank of Montreal v. Innovation Credit Union.*[33] The priority competition was between a PPSA security interest and a federal *Bank Act*[34] security. The *Bank Act* security is not a security interest covered by the PPSA, and the federal provisions that governed it do not create a comprehensive set of priority rules.[35] The matter therefore fell to be determined through the application of conventional property law principles. In applying these principles, the court stated:[36]

> It is true that the internal priority rules of the *PPSA* cannot be invoked to resolve the dispute. However, it does not follow that the provincial security interest created under the *PPSA* does not exist outside these priority rules. Nor can the fundamental changes brought about by the *PPSA* be ignored in determining the nature of the prior competing interest.

[33] 2010 SCC 47.
[34] S.C. 1991, c. 46.
[35] The co-existence of two security regimes – one based on traditional property law concepts and the other that ranks priority according to the time of registration has generated much litigation. See R.C.C. Cuming, "PPSA — Section 178 *Bank Act* Overlap — No Closer to Solutions" (1991) 18 Can. Bus. L.J. 135 and J.S. Ziegel, "The Interaction of Section 178 Security Interests and Provincial PPSA Security Interests: Once More into the Black Hole" (1991) 6 B.F.L.R. 323; R.J. Wood, "The Nature and Definition of Federal Security Interests" (2000) 34 Can. Bus. L.J. 65. Although the Law Commission of Canada recommended repeal of the Bank Act security provisions, there has been no progress on this front. See *Modernizing Canada's Secured Transactions Law: The* Bank Act *Security Provisions* (Ottawa: Law Commission of Canada, 2004).
[36] *Supra* note 33 at para. 30.

The Court went on to observe that although some of the pre-PPSA security devices created equitable rather than legal interests, the PPSA treats them all equally as security interests.[37] Because the PPSA security interest is recognized and regulated by statute, it is to be regarded as a legal interest that operates by way of security.

A PPSA security interest is different from the historical concept of the floating charge in two essential respects. First, the secured party obtains a legal rather than an equitable interest.[38] Secondly, the legal interest is fixed rather than floating and arises as soon as the conditions for attachment have been satisfied. The transformation has had the effect of elevating the priority status of a PPSA security interest over that formerly obtained by a floating charge under pre-reform law.

vi) Legislative Superpriority Provisions

The vast majority of income tax revenue in Canada is collected through a system of source deduction that requires employers to deduct amounts from the pay of their employees and remit it to the taxation authority. Although an employer is required to hold these amounts in trust, an insolvent employer will often fail to do so with the result that the common law requirements for the creation of a trust will not have been satisfied. In order to give the taxation authority a proprietary interest in the debtor's assets, the taxation legislation imposes a statutory deemed trust on the assets of the debtor.[39] Upon the insolvency of the employer, priority competitions frequently arise between prior secured parties and the statutory deemed trusts in respect of source deductions.

Prior to the PPSA, Canadian courts resolved these priority competitions through the application of conventional property law principles. A prior fixed charge had priority over a subsequent statutory deemed trust, since the latter only operated in respect of the debtor's interest in the asset.[40] The situation was different if the security interest took the form of a floating charge.

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[37] *Ibid.*, at para. 42.
[38] See also *i Trade Finance Inc. v. Bank of Montreal*, 2011 SCC 26 at para. 61 in which the court characterized a PPSA security interest as a legal interest since the interest is recognized by statute.
[39] *Income Tax Act*, R.S.C. 1985, c.1 (5th Supp.), s.227(4).
[40] *Board of Industrial Relations v. Avco Financial Services Realty Ltd*, [1979] 2 S.C.R. 699.

Canadian courts held that the statutory deemed trust was entitled to priority if it arose before crystallization of the floating charge.[41] As a result, the statutory deemed trust was typically subordinate to a fixed charge, but usually had priority over a floating charge.

The implementation of the PPSA disturbed this equilibrium and provided a nasty shock to the taxation authority. Secured creditors were able to take security interests in all the assets of the debtor and these security interests were no longer regarded as floating charges. They were fixed legal interests that attached to new assets the moment that the debtor acquired rights in the property. Since the PPSA security interest attached to the asset before the statutory deemed trust arose, the security interest was entitled to priority over the statutory deemed trust.[42]

The victory was only temporary. Parliament soon passed amendments to ensure that the statutory deemed trust was given priority.[43] The legislation, however, did not simply attempt a return to the status quo. The statutory deemed trust was afforded a priority over almost all prior or subsequent security interests of any nature.[44]

There are many other types of non-consensual security interests in Canada. In many cases they secure claims owed to the Crown, but some are in favour of other claimants such as unpaid employees.[45] Often the non-consensual security interest is afforded a superpriority over other security interests, but sometime there is an exception made for specified kinds of interests such as purchase-money security interests.[46] In some instances, the priority is capped by a monetary limit, or imposed only against certain types of assets.[47] The trend in drafting these provisions has been to use PPSA concepts and terminology, and when this is done there are generally few

[41] *Dauphin Plains Credit Union Ltd. v. Xyloid Industries Ltd.*, [1980] 1 S.C.R. 1182.
[42] *Royal Bank of Canada v. Sparrow Electric Corp.*, [1997] 1 S.C.R. 411.
[43] *Income Tax Act*, R.S.C. 1985, c.1 (5th Supp.), s.227(4.1).
[44] The one exception is a registered mortgage on land, but only in respect of amounts that are due before the deemed trust arises.
[45] See *Bankruptcy and Insolvency Act*, R.S.C. 1985, c B-3, s.81.3.
[46] See, *e.g.*, *Employment Standards Code*, R.S.A. 2000, c E-9, s.109(3)-(4) which provides that a claim for unpaid wages has priority over a security interest other than a prior registered purchase money security interest.
[47] The statutory security in respect of unpaid wages created by the *Bankruptcy and Insolvency Act*, R.S.C. 1985, c B-3, s.81.3 is capped at $2000 for each employee and covers only cash, cash equivalents, inventory, accounts, and proceeds from any dealing with those assets.

problems of interpretation.[48] As will be seen, difficulties are more likely to arise when the statute adheres to older concepts and terminology of pre-PPSA law.

b) The Characterization of Title Retention Devices

The application of the PPSA to title retention devices was relatively uncontroversial in Canada. Conditional sales agreements were subject to a registration requirement under pre-PPSA law.[49] In this respect, Canadian law shared a greater affinity with the pre-reform law of the United States. Accordingly, it was not a large conceptual leap to assimilate them with other security devices. Canadian courts had greater difficulty with the idea that leases were to be brought within the scope of the Act, but resistance to this idea has largely passed.[50]

Problems have arisen when the issue is not expressly governed by the PPSA. It might become necessary to characterize the interest of the conditional seller for the purposes of sales law or some other body of law. Do we consider the conditional seller to be the owner who holds legal title to the goods? Or is the buyer the owner?

The Uniform Commercial Code of the United States was unequivocal on this issue. It provided that a retention of title was limited in effect to a reservation of a security.[51] The property in the goods would pass immediately to the buyer according to ordinary sales law principles and the seller would have nothing more than a security interest in the debtor's newly acquired asset in order to secure the unpaid purchase price and credit charges. Unfortunately, the drafters of the Canadian legislation thought in unnecessary to include a similar provision, and Canadian courts have not adopted a consistent approach when confronted with this issue.

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[48] See, *e.g., Workers Compensation Act*, R.S.A. 2000, c W-15, s.129(3) which provides that the assessment has priority over all security interests as defined in the PPSA.
[49] See J.S. Ziegel, "Canadian Chattel Security Law: Past Experience and Current Developments" in J.G. Sauveplanne, ed. *Security over Corporeal Moveables* (Lieden:A.W. Sijthoff, 1971) 71.
[50] Judicial resistance to the idea was finally laid to rest by the Supreme Court of Canada in *Giffen, Re*, [1998] 1 S.C.R. 91. Prior to this, some courts were troubled by the idea that an unregistered lease should be rendered ineffective against a trustee in bankruptcy, and employed a number of different techniques to avoid this outcome.
[51] Uniform Commercial Code, 2-401(1).

i) Competitions with non-PPSA Interests

The courts were again called upon to resolve a priority competition between a statutory deemed trust and a PPSA security interest – this time in the form of a conditional sales agreement or finance lease.[52] The federal legislation gives the deemed trust priority over any security interest.[53] Although title retention devices are clearly security interests for the purposes of the PPSA, the issue was whether they should also be characterized as such for the purposes of the federal legislation. The legislation defines a security interest as "any interest that secures payment or performance of an obligation..."[54] This portion closely tracks the PPSA definition, and one would be forgiven for thinking that the courts would give them the same construction.

This did not happen. The courts seized upon the concluding portion of the definition, which indicated that it included an interest that arose out of a mortgage, pledge, lien or charge. The failure to include title retention devices among this enumeration was thought to show an intention to exclude such security interests from the scope of the provision. The result was that a title retention device enjoyed priority over the statutory deemed trust.

These decisions were perhaps motivated by a wish to curtail the long reach of the statutory deemed trust. The difficulty is that Canadian insolvency statutes also define a security interest as a mortgage, charge, lien or pledge. The decisions therefore have the potential to undermine several key insolvency policies by excluding title retention devices from the scope of the insolvency definition.[55]

ii) Passage of Property under Title Retention Agreements

The use of a conditional sales agreement brings both sales law and secured transactions law into play. The contract involves a credit sale of the goods from the seller to the buyer. It also involves the creation of a security interest to secure the obligation to pay. Canadian courts have had little

[52] *DaimlerChrysler Financial Services (Debis) Canada Inc. v. Mega Pets Ltd.* (2002), 212 D.L.R. (4th) 41 (B.C.C.A.); *Minister of National Revenue v. Schwab Construction Ltd*. (2002), 31 C.B.R. (4th) 75 (Sask. C.A.); *Bank of Nova Scotia v. Turyders Trucking Ltd.* (2001), 32 C.B.R. (4th) 14 (Ont. S.C.J.).
[53] *Income Tax Act*, R.S.C. 1985, c.1 (5th Supp.), s.224(4.1).
[54] *Ibid.*, s.224(1.3).
[55] See R.J. Wood, "The Definition of Secured Creditor in Insolvency Law" (2010), 25 B.F.L.R. 341.

difficulty with the latter aspect. The transaction creates a security interest, and its priority will be governed by the PPSA. But sometimes it is the sales aspect that is relevant, and it is here that there is greater controversy.

Consider the case where a business has given a security interest in all of its property to a lender. The grantor then sells some of its goods to a buyer under a conditional sales contract. This does not involve a competition between secured parties. It is essentially a competition between the secured party (the lender) and the buyer. The PPSA provides rules that govern competitions between secured parties and buyers. Canadian courts have not been in agreement on precisely when they can be invoked. The Saskatchewan Court of Appeal has taken the view that these rules will not apply unless the buyer has acquired property in the goods.[56] The Ontario Court of Appeal refused to adopt this approach and took the view that the priority rules could operate even if title did not pass so long as it was possible to identify the goods to the contract.[57] The Ontario decision involved a buyer who had purchased an expensive boat under a conditional sales agreement and had paid 90 per cent of the purchase price. The concern was that the sales agreement delayed the passage of property until the full purchase price was paid. As this had not yet occurred, the conditional buyer would be unable to invoke the ordinary course buyer rule that would otherwise allow a buyer to take free of a security interest given by the seller.

The problem would be greatly lessened had the Ontario Court of Appeal had recharacterized the nature and effect of a title retention clause.[58] If the clause had been viewed as creating a security interest and having no other effect, it would not have delayed the passage of property to the buyer. This matter would be determined through the application of sales law without regard to the title retention clause. In the vast majority of cases that involve the sale of specific goods, this occurs the moment when the contract is entered into.[59]

[56] *Royal Bank v. 216200 Alberta Ltd.*, [1987] 1 W.W.R. 545 (Sask C.A.).
[57] *Spittlehouse v. Northshore Marine Inc.* (1994), 18 O.R. (3d) 60.
[58] See Jacob Ziegal, Commentary, "To what types of sale does section 28(1) of the OPPSA apply?" (1994–95) 24 Can. Bus. L.J. 457.
[59] See *Sale of Goods Act*, R.S.S. 1978, s. S-1, s.20 Rule 1.

4. The Substance Test of a Security Interest

The second aspect of the PPSA concept of a security interest involves the idea that the characterization of a transaction as a security interest should depend upon its function rather than the form of the transaction or the location of title. The emphasis is now on the economic realities. If the effect of the transaction is such that a debtor has given a creditor a proprietary right in the debtor's assets such that the creditor may have recourse to the assets in the event of a default, it is to be regarded as a security interest. The fact that the parties may have set it up as a lease, consignment, bailment, trust or other transaction is not relevant if the transaction functions as a security interest.

The application of the substance test is illustrated in three different situations. The first shows how an inquiry into the economic realities may result in the characterization of a lease as a security interest even if the lessee is not expected to acquire title to the goods at the end of the lease term or enjoy possession of the goods for their full useful life. The second deals with the application of the test to new forms of security arrangement, and illustrates the point that there can be no new forms of security arrangements that fall outside the scope of the Act. The third is the most controversial in Canada and concerns the characterization of an arrangement as a security interest despite the fact that under pre-reform law the transaction would be regarded as giving rise only to personal rather than proprietary rights. It therefore represents the outside limits of the substance test.

a) Open End Leases

Canadian courts were often called upon to distinguish between true leases and leases that in substance created a security interest (a "security lease").[60] The courts often found it useful to draw an analogy between a security lease and a secured installment purchase agreement (a

[60] Canadian case law from Ontario and Manitoba are particularly rich in decisions dealing with the characterization of leases. The PPSA of these provinces did not originally bring true long term leases within the scope of the Act as deemed security interests. As a result, registration was required for security leases, but was not required in respect of true leases. Most of these cases involved priority competitions with a trustee in bankruptcy of the lessee or with a secured party whose security interest covered the leased goods. Both provinces have since amended their legislation by bringing leases for a term of more than one year within the scope of the PPSA as deemed security interests. Not surprisingly, this has resulted in a sharp drop in the number of cases litigated on the characterization issue since registration is now required to obtain priority for both security leases and true leases.

conditional sale under the former law).[61] Upon paying the full purchase price and credit charges, the buyer under a secured installment purchase agreement ends up with unencumbered title to the goods. If the lease were structured such that title to the goods automatically vested in the lessee[62], or if a lease option was structured so that a rational lessee would exercise an option to purchase (because the option price was substantially less than the expected residual value of the goods at the end of the lease term), one could say that there was functionally no real difference between the two devices. In both instances, the party winds up as the owner of the asset.

Although Canadian courts sometimes tested the transaction by inquiring whether the lessee was expected to end up as owner,[63] this was simply an application of the more general "substance test" to the particular facts. The intent was never to substitute an ownership test for the substance test.

This point is confirmed in the Canadian cases dealing with open end leases. Open end leases set a termination value. At the end of the lease term, the goods are returned to the lessor and sold. If the sale proceeds exceed the termination value, the surplus is paid to the lessee. If the sale proceeds are less than the termination value, the lessee is responsible for paying the deficiency. Under this arrangement, the lessee is not expected to become the owner of the goods as the goods as sold to a third party buyer. An insistence that the lessee acquire ownership or enjoy possession of the goods for their full useful life would mean that an open end lease would not be characterized as a security interest.

The courts did not take so narrow an approach, but instead gave full effect to the substance test.[64] The fact that the lessee did not acquire ownership was not the *sine qua non*. The essential consideration was that the lessee occupied the economic position of an owner. The lessee had the benefits and disadvantages of ownership – the risk of gain or loss. From an economic

[61] See *Federal Business Development Bank v. Bramalea Ltd*. (1983), 144 D.L.R. (3d) 410 (Ont. H.C.J.), aff'd 150 D.L.R. (3d) 768 (Ont. C.A.).
[62] *DaimlerChrysler Services Canada Inc. v. Cameron,* (2007, 279 D.L.R. (4th) 629 (B.C.C.A.).
[63] See, *e.g., Stark Coaxial Systems Inc., Re,* (1985), 55 C.B.R. (N.S.) 308 (Ont. S.C.)
[64] See *Crop & Soil Service Inc. v. Oxford Leaseway Ltd*. (2000), 186 D.L.R. (4th) 85 (Ont. C.A.); *HOJ Franchise Systems Inc. v. Municipal Savings & Loan Corp.* (1994), 6 P.P.S.A.C. (2d) 302 (Ont. Ct. Gen. Div.).

perspective, there was no difference between a transfer of title to the lessee and a forced sale of the goods for the account of the lessee.[65]

b) New Forms of Security – Feeder Association Agreements

The application of the PPSA to feeder association agreements provides a good illustration of the all encompassing nature of the substance test and the idea that there can be no new secured transactions that fall outside the scope of the PPSA. Feeder associations are organizations that provide feed to livestock producers. A feeder association acquires cattle and brands them (or identifies them with an ear tag) in the name of the feeder association. The feeder association then enters into an agreement with a member of the feeder association who takes possession of the livestock and raises them. The agreement provides that the legal title to the livestock remains with the feeder association. The member is responsible for maintaining the health of the livestock, must provide them with veterinary services and must insure them. The feeder association provides credit to the member to permit the purchase of feed. When the cattle are sold, the charges payable to the feeder association are paid and the balance is paid to the producer.

The use of feeder association agreements is a relatively new phenomenon. Canadian courts were called upon to determine if these agreements in substance created security interests.[66] From an economic perspective, the matter is clear cut. Despite the fact that the feeder association holds legal title to the livestock, the producer is in the economic position of an owner. The producer has the benefit of gain and the risk of loss, while the feeder association is assured that the credit it supplies will be recovered. In many respects, the analysis is similar to that applied in respect of open end leases. It makes no difference that the producer never acquires legal title at any time. The focus is upon substance not form, on the economic realities and not the location of legal title.

[65] *Re Cronin Fire Equipment Ltd.* (1993), 21 C.B.R. (3d) 127 (Ont. Ct. Gen. Div.).
[66] *Farm Credit Corp. v. Valley Beef Producers Co-operative Ltd.* (2002) 36 C.B.R. (4th) 121 (Sask. C.A.); *Toronto Dominion Bank v. East Central Feeder Co-operative Ltd.*, (2001), 2 P.P.S.A.C. (3d) 283 (Ont. S.C.J.).

c) Set-Off and Flawed Asset Arrangements

The Canadian personal property security statutes, unlike the statutes in Australia and New Zealand, do not contain a provision that brings flawed asset arrangements with their scope.[67] This is perhaps not as surprising as it may seem. Until recently, there was a large gap in the Canadian case law. First, there was no guidance on the question whether it was even possible for a party to be granted a security interest in an obligation that was owed by the secured party to the grantor.[68] Secondly, there was absolutely no guidance on the nature or character of a "flawed asset" arrangement. Indeed, the term could not be found in any Canadian decision. All this changed with the release of the Supreme Court of Canada's decision in *Caisse populaire de Drummond v. Canada*.[69]

i) The Decision of the Supreme Court of Canada

The controversy again concerned the federal statutory deemed trust that secures source deductions. A financial institution had extended an operating line of credit to the debtor. The parties entered into two agreements. The first was a term savings agreement under which the debtor deposited $200,000 with the financial institution. The term was for five years and the funds could not be redeemed before that date. The agreement also provided that the deposit was not transferrable and could only be given as security to the financial institution.

The second agreement contained three elements. First, it provided that the debtor consented to the withholding of the $200,000 term deposit until all the amounts due under the credit agreements were fully repaid. Secondly, it provided that in the event of default the financial institution could claim compensation (the civil law counterpart to set-off in common law systems) between the term deposit and the amount due under the credit contracts. Thirdly, the debtor pledged and hypothecated the term deposit as security for the loans. The debtor had failed to remit source deductions both before and after the agreements had been entered into. The financial institution did not immediately enforce its claim against the term deposit. Shortly after the insolvency proceedings were instituted against the debtor, the financial institution purported

[67] PPSA, s.12(2)(l).
[68] See R.J. Wood, Journey to the Outer Limits of Secured Transactions Law: *Caisse populaire Desjardin de l'Est de Drummond*" (2010) 48 C.B.L.J. 482 at 491.
[69] [2009] 2 S.C.R. 94.

to close out the account in realization of its security and the Crown claimed that the term deposit was subject to its statutory deemed trust.

The legislation that created the statutory deemed trust provided that it ranked ahead of any security interest in the assets. Clearly, any attempt to assert the security interest against the Crown was doomed to failure. For this reason, the financial institution did not elect to assert its security interest against the term deposit. Instead, it claimed that its agreement gave it the contractual right to withhold the term deposit until the amounts owing to it were paid. The issue was whether these other contractual provisions constituted a security interest within the meaning of the federal provision.[70] If so, the statutory deemed trust would be entitled to priority. If not, the statutory deemed trust would only be effective in respect of unremitted source deductions that were due at the time the term deposit was created and would be ineffective in respect of any unremitted amounts that arose after the creation of the contractual rights in favour of the financial institution.

The majority judgment found that the contractual provisions satisfied the definition of a security interest. Rothstein, J. held that arrangement will constitute a security interest if the substance of the transaction was that the creditor acquired an interest in the debtor's property so as to ensure that the right of set-off or compensation would provide an effective remedy on default in payment of an obligation. He held that the five year term, the contractual right to withhold payment and the restrictions on transfer created a security interest. The provisions were designed to "encumber" the term deposit to ensure that it would be available on a default in repaying the loans.[71]

The dissenting judgment took the view that the contractual provisions only gave rise to personal rights, and did not create proprietary rights in the term deposit. The length of the term merely defined the timing of the repayment obligation. A negative pledge covenant merely gives the contracting a right to sue for damages for breach. The right to withhold merely imposed a

[70] The issue was not whether the arrangement fell within the definition of a security interest in the PPSA. However, the federal definition of a security interest did not vary materially from the definition contained in the PPSA in this respect, and therefore the case is generally regarded as authoritative on the scope of the PPSA as well. However, differences in the wording of the provisions have been held to be significant in other contexts. These will be discussed in the next section dealing with the characterization of conditional sales agreements.

[71] *Supra*, note 69 at para. 30.

condition that was required to be satisfied in order to obtain payment of the term deposit. None of these rights individually or in tandem created a security interest.[72]

ii) The Application of the Substance Test

The decision is important in that it demonstrates the astonishing breadth of the substance test. When a lease, trust, bailment or consignment is used to provide a creditor with security for payment of an obligation, there is no question that the creditor has some kind of proprietary right in the asset, if only possession.[73] The issue is whether this proprietary interest is held as security. But the issue in *Caisse populaire de Drummond v. Canada* was whether a combination of personal rights could constitute a security interest if their effect was to secure payment of an obligation. The court held that if the contractual provisions effectively placed the creditor in the same position as it would have occupied had it been granted a security interest, it would be characterized as such.

Outside of Canada, this aspect of the decision may seem, at first, to be of lesser importance. The decision places Canada in the same camp as New Zealand and Australia, which have expressly included flawed asset arrangements within the scope of their Acts. But on closer reflection, it should be apparent that the decision has a wider significance. The reasoning is not restricted to flawed asset arrangements, but is relevant whenever contractual rights are used to create a set of rights that are functionally equivalent to a security interest.

iii) The Priority Consequences of the Decision

Characterization of the transaction as a security interest was significant in the case because it triggered federal priority provision that gave the statutory deemed trust priority over a security interest. But the decision has a broader implication. If the transaction is characterized as a security interest, then it must be perfected under the PPSA in order obtain priority over other

[72] *Ibid.* at para 122.
[73] PPSA, s.20(5) makes it clear that a lessee or bailee of goods under a PPSA lease or a buyer under a conditional sales agreement has rights in the goods when that person obtains possession of the goods.

secured parties. It must also be perfected in order to be effective in some insolvency proceedings. The degree to which this is viewed as a concern very much depends on the perfection and priority rules that are in place. It is here that there is significant variation across jurisdictions.

Canada and New Zealand do not provide any special perfection or priority rules in respect of a deposit account with a financial institution. This account, like any other account, can only be perfected by registration. In Canada, this perfection requirement has caused concerns in the derivatives industry over cash collateral transactions in which cash is provided as credit support for exposure on derivatives and securities financing transactions. Under these transactions, a party will wire funds to its counterparty. The funds are held in a bank account in the name of the counterparty. If the documentation provides that the counterparty is granted a security interest in the funds that are transferred, the transaction clearly creates a security interest and is governed by the PPSA. This would mean that registration would be required to perfect the security interest.

In order to work around this requirement, the Canadian practice has been to structure the transaction as an absolute transfer of the funds to the counterparty.[74] This creates a debtor-creditor relationship between the parties. The credit support document also provides that the counterparty has the right to set-off the obligations owed by the transferor of the funds against its obligation to repay the transferred funds. The decision of the Supreme Court of Canada has caused consternation because of the potential for this form of transaction to be characterized as a security interest, and thereby give rise to the requirement for registration to perfect it.[75]

The response of the derivatives industry has been to request amendments to the Canadian PPSAs in order to introduce the concept of perfection by control of deposit accounts and the corresponding priority and conflicts rules that are found in the Article 9 of the Uniform Commercial Code.[76] Under Article 9, a security interest in a deposit account can be perfected by control by becoming the bank's customer, or by entering into an agreement under which the bank

[74] See International Swaps and Derivatives Association Inc., "Proposal for Amendments to the Treatment of Deposit Accounts under the PPSA" (June 8, 2009) online: http://www.isda.org/c_and_a/pdf/ISDA-Proposal-for-Amendments-to-Treatment-of-Deposit-Accounts-under-PPSA-8June2009.pdf.
[75] See International Swaps and Derivatives Association Inc., Letter to Alberta and Ontario Governments re Proposal for Amendments to the Treatment of Deposit Accounts under the PPSA (April 13, 2010) online: http://www.isda.org/speeches/pdf/ISDA-Letter-to-Alberta-and-Ontario-Governments.pdf.
[76] *Ibid.*

agrees to comply with the instructions of the secured party directing disposition of the funds without further consent by the debtor.[77] If the secured party is the bank, the security interest is automatically perfected by control.[78] No other method of perfection is effective in respect of deposit accounts under Article 9.[79] Competing security interests in the deposit account is determined in accordance with the following rules:

- A security interest perfected by control has priority over a security interest that is not perfected by control.[80]

- If both security interests are perfected by control, first priority goes to a secured party who obtains control by becoming the bank's customer in respect of the deposit account.[81]

- Second priority goes to a bank which has taken a security interest in the deposit account (the funds that it owes to its depositor).[82]

- Thereafter, priority is given to the secured party who was first to perfect by control.[83]

The proposal to adopt the Article 9 approach has been highly controversial. Although some have argued strongly in its favour, others have argued that it goes too far in its adoption of non-temporal priority rules and that it unduly favours banks over other commercial parties. This is illustrated in the following example:

> SP takes and perfects a purchase money security interest in inventory. The inventory is sold and the proceeds are deposited in a bank account. Thereafter, the bank makes a loan to its customer and takes a security interest in the deposit account to secure the loan. The

[77] It is not necessary for the secured party to have exclusive control over the account pursuant to the agreement. U.C.C. 9-104(b) provides that a secured party has control even if the debtor retains the right to direct the disposition of funds from the deposit account.
[78] U.C.C. 9-104 and 9-314.
[79] U.C.C. 9-312(b)(1).
[80] U.C.C. 9-327(1).
[81] U.C.C. 9-327(4).
[82] U.C.C. 9-327(3).
[83] U.C.C. 9-327(2).

bank has priority over SP, and this holds true even if the bank knew of SP's security interest in the proceeds.[84]

This has led to the development of a number of reform proposals in Canada. One proposal would adopt the Article 9 perfection by control concept, but exclude operating accounts and accounts maintained primarily for personal, family or household purposes from its operation.[85] Another response is to create a "blocked account security interest" that would require notice to holders of prior registered security interests.[86]

iv) Concurrent Security Interest and the Set-Off Right

The last aspect of the decision concerns the interplay between security interests and set-off rights. The commercial practice has tended towards the creation of multiple devices in the belief that if there is a problem with the operation of one of them, one or the other can be used as a backup. The "triple cocktail" of a security interest, a flawed asset arrangement, and a contractual right of set-off is the classic example of this phenomenon.[87] There no longer seems to be any point in combining a security interest and a flawed asset arrangement under the PPSA. A flawed asset arrangement is regarded as a kind of security interest, and therefore it creates nothing more than that which is already granted by way of a security interest.

The interplay between a security interest and a right of set-off is a little more involved. *Caisse populaire de Drummond v. Canada* was decided on the basis that the requirements for legal compensation (the civil law counterpart to set-off) had not been satisfied. The implication is that

[84] Comment 5 of the Official Commentary to 9-327 indicates that "[a] secured party who claims the deposit account as proceeds of other collateral can reduce the risk of becoming junior by obtaining the debtor's agreement to deposit proceeds into a specific cash collateral account and obtaining the agreement of that bank to subordinate all its claims to those of secured party." It goes on to note that this arrangement will not be effective if the debtor violates this arrangement and deposits the proceeds into a deposit account instead of the cash collateral account.

[85] R.M. Scavone, "Should the PPSA be amended to Permit Security Interests in Deposit Accounts to be Perfected Through Control?" (November 23, 2010) (on file with author) canvasses some of the options. It is likely that the Personal Property Security Act Subcommittee of the Ontario Bar Association will endorse amendments that permit perfection by control, but exclude personal and operating accounts.

[86] R.C.C. Cuming, "Memorandum on Security Interests in Deposit Accounts" (December 30, 2010) (on file with author).

[87] See P. Wood, *Set-Off and Netting, Derivatives, Clearing Systems*, 2nd ed. (London: Sweet & Maxwell, 2007) at 13.

the secured party is entitled to assert set-off or legal compensation if the conditions for its exercise has been satisfied, and it is not precluded from doing so by virtue of taking a security interest in the account that it owes to the debtor. This point is uncontroversial. There is no reason in principle why the granting of a security interest in the debt should deprive the secured party of its right to legal or equitable set-off. The same should hold true in respect of a contractual right of set-off. A contractual right of set-off is frequently employed to create a right of set-off in circumstances where it would not otherwise be permitted. For example, contractual set-off can be used to permit a party to set-off claims owed to it by the other party as well as claims owed to it by affiliated entities of the other party. Again, there is no reason why the granting of a security interest in the debt should affect the exercise of this right.

The situation is otherwise when the security interest arises from a transaction that creates a contractual right of set-off that comes into operation only on default, and is combined with contractual features that are designed to prevent the debtor from collecting, disposing of, or encumbering the asset. The Supreme Court of Canada held that this type of transaction should be characterized as a security interest. The contractual right of set-off only comes into operation upon a default and is therefore only a mechanism through which the security interest is enforced. This type of contractual set-off right is not capable on being independently enforced, but is an integral part of the security interest.

5. Legislative Differences

Although the Australian PPSA drew heavily from the Canadian Acts for inspiration, it would be a mistake to regard it as merely a variant of the Canadian model. The legislators adhered to the fundamental principles of the PPSA reform, but often developed different designs and strategies for their implementation. The Australian Act exists as a separate branch of the PPSA family – sharing a close resemblance to the Canadian and New Zealand Acts on many matters, but strikingly different on others. These legislative differences must always be carefully considered when determining if the case law of other PPSA jurisdictions might be relevant.

The unitary concept of a security interest and the substance test for a security interest are central features of PPSA reform, and for this reason there are fewer substantive differences in respect of

this element amongst the various personal property security statutes. The case law from Canada, the United States and New Zealand can reasonably be expected to have greater influence when the issue concerns the concept of a security interest under the Australian PPSA.

But even here, difference in the legislative framework will greatly affect the kinds of issues that will come before the courts. Australia has had the very good fortune of being able to implement PPSA reform in one fell swoop. There has been a much greater effort to make adjustments to other pieces of legislation to take into account the new PPSA concepts. For example, references to the now obsolete concept of the floating charges contained in the *Corporations Act 2001* are replaced by references to circulating security interests.[88]

This is very different from implementation of the reforms in Canada. The reform took place over the course of three decades as one province after another joined the fold. The federal government was not involved in the reform initiatives, and the federal legislation has never been comprehensively amended to take into account the new concepts and terminology of the PPSA.[89] As a result, there has been more work for the courts in Canada in attempting to reconcile the obsolete pre-reform language of the federal statutes with the newer concepts and terminology of the PPSA. One can therefore anticipate that these sorts of issues are less likely to come before the courts in Australia because the groundwork in harmonizing the provisions has already been accomplished.

On other matters, the effect of legislative differences may be more pronounced. In Canada, the characterization of a flawed asset arrangement as a security interest has led to calls in some quarters for amendments that would permit perfection by control in respect of deposit accounts. The characterization of the transaction is significant for two reasons. First, it means that it must be perfected in order to achieve the highest level of priority over competing third parties. Secondly, it means that the interest was subordinated to the federal statutory deemed trust in respect of source deductions.

[88] In doing so the status quo in terms of priority ranking is maintained. The drawback is that it also preserves the uncertainty in determining what degree of control is sufficient to trigger the operation of the provision. Although the concept of the floating charge has fallen out of the picture, some of the old debates associated with its use continue in the new system in a different guise.

[89] See Cuming, Walsh & Wood, *supra*, note 4 at 169-74.

The characterization of a flawed asset arrangement as a security interest simply does not have the same resonance in Australia. Deposit taking institutions are unlikely to be concerned because the Australia PPSA permits automatic perfection by control of ADI accounts when the secured party is an ADI.[90] There is no worry about registration because none is required. There is no worry about priority because a security interest perfected by control has priority over a security interest not perfected by control,[91] and only the ADI can perfect by control. The Australian derivatives industry is unaffected because their credit support agreements are structured on the basis of the netting of accounts rather than the granting of security in collateral, and the PPSA expressly excludes such transactions from its scope.[92] If there is to be an outcry in Australia, it will not come from these sectors. It might, however, come from other commercial credit grantors who may question why the legislators thought it appropriate to give ADIs the exceptional benefits of automatic perfection and first priority at their expense.[93]

6. Conclusion

Canadian courts have had little difficulty with adapting the floating charge in light of the unitary concept of a security interest. The concept of a floating security interest simply ceases to exist. It is replaced by the concept of a fixed legal security interest that is subject to a licence that permits the debtor to deal with the assets free from the security interest in respect of authorized transactions. The adaptation of the conditional sales has been somewhat more problematic. Courts have sometimes reverted to the older thinking and have failed to fully assimilate them with other security interests. To be fair, the courts in these cases were sometimes dealing with federal statutes that used pre-reform terminology and concepts, and this has made the passage more treacherous. There are two lessons in this. The first is that a clear statement that the

[90] The Australian PPSA is very different from Article 9 in this respect. Perfection by control of an ADI can be achieved if, and only if, the secured party is the ADI. See PPSA, s.25. An extended meaning of control is, however, retained in respect of the definition of a circulating asset security interest.
[91] PPSA, s.57(1).
[92] PPSA, s.8(1)(e). There is no similar exemption in the Canadian Acts. The problem in Canada is that a credit support agreement that is structured as a security interest requires registration to perfect it (because a transfer of funds into a deposit account in the name of the secured party does not perfect it by control). But structuring it as a netting of accounts is also risky as the transaction might be characterized as a security interest on the basis of the Supreme Court of Canada's decision in *Caisse populaire de Drummond v. Canada*, *supra*, note 69.
[93] For a critique of the Article 9 approach, see W. Gibson, "Banks Reign Supreme under Revised Article 9 Deposit Account Rules" (2005), 30 Delaware Journal of Corporate Law 819.

retention of title only operates to create a security interest would have been useful. Secondly, the culling of the pre-PPSA terminology and a replacement with terminology that accords with that found in the PPSA would also have helped to prevent a reversion to pre-PPSA modes of analysis.

Canadian courts have also fully embraced the substance test for determining if a transaction is to be characterized as a security interest, and have made important strides in working out an appropriate methodology for uncovering disguised security interests. There is now an extensive body of case law that has been developed on the characterization of leases, consignments and trusts. As well, Canadian courts have applied the substance test to new forms of commercial transactions and in doing so have confirmed the correctness of Grant Gilmore's view of the "all-embracing, all devouring"[94] character of the PPSA.

Because the unitary concept of a security interest and the substance test are central features of Article 9 and every PPSA, there is less likelihood that differences in drafting or variations in policy will impede the creation of a truly international body of case law on these issues. Legislative differences are more likely to affect the kinds of cases that come before the court. Although issues concerning flawed asset arrangements are highly contentious in Canada, they may be less so in Australia because of the ability of the deposit taking institution to perfect its security interest automatically by control without any need for registration. Implementation of the Canadian PPSA occurred over three decades at the provincial level with the result that many of the statutory provisions continue to adhere to now obsolete concepts and terminology. The "big bang" implementation of the Australian PPSA brings simultaneous reforms of commonwealth, state and territory legislation, and this will also reduce the need for these types of issues to be litigated.

[94] *Supra*, note 12.