Modernizing Canada's Secured Transactions Law: The *Bank Act* Security Provisions

LAW COMMISSION OF CANADA
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The Honourable Irwin Cotler
Minister of Justice and Attorney General of Canada
Justice Building
Wellington Street
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Dear Minister:

In accordance with section 5(1)(c) of the *Law Commission of Canada Act*, we are pleased to submit the Report of the Law Commission of Canada on modernizing Canada's secured transactions law to produce a fair, efficient and less complex legal environment for extending secured credit.

Yours sincerely,

Nathalie Des Rosiers, President	Bernard Colas, Commissioner
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Executive Summary

Canada needs a fair, efficient, and less complex legal environment for extending secured credit because the availability of credit enables businesses to fund current and future projects, and that contributes to the health of our national economy.

The existing secured transactions regime provided by the *Bank Act* security provisions, dates back to 1890. While it has undergone a series of amendments, it has never undergone a coherent, comprehensive modernization. Meanwhile, every province and territory has enacted modern secured transactions regimes. The co-existence of an outmoded federal regime with modernized provincial/territorial regimes produces considerable uncertainty, which seriously undermines the efficiency of Canada's secured transactions law.

In this Report, the Law Commission of Canada traces the evolution of secured transactions regimes. It then discusses four categories of problems caused by the *Bank Act* security provisions: statutory obsolescence, competing federal–provincial/territorial priorities, dual registry and the pre-emption of provincial/territorial legislative objectives.

The Commission identified three principles for guiding reform of the secured transactions provisions of the *Bank Act*.

- Principle 1: The problems associated with the co-existence of two legal regimes governing security interests in personal property should be addressed to increase the predictability of outcomes and to ensure that the legal regimes governing secured credit are efficient and effective.

- Principle 2: Federal secured transactions law should utilize terminology and concepts that are compatible with both the civil law system of Quebec as well as the common law systems of the other provinces and territories.

- Principle 3: Federal secured transactions law should not interfere with valid provincial and territorial legislative measures that are generally applicable within the provinces and territories unless it is necessary to achieve an identified federal objective.

These principles are used to assess the advantages and disadvantages of three reform options: amend the *Bank Act* provisions, create a federal *Personal Property Security Act*, or repeal the *Bank Act* provisions.

Based on its analysis, the Commission recommends that Parliament eliminate the *Bank Act* security regime by repealing sections 427 to 429 of the *Bank Act*. This option best meets the criteria of the three guiding principles. It is also most likely to create greater certainty in legal outcomes, and a more efficient and effective secured transactions regime.

1. Introduction

The availability of credit is critically important to our economy. If businesses had to rely on their own cash flow to fund their current and future projects, they would need to drastically cut back on their activities. This would have a seriously detrimental effect on their business activities as well as on the national economy. Countries with legal systems that restrict the ability of businesses to obtain loans operate under a competitive disadvantage.[1]

Every Canadian province and territory has enacted a modern secured transactions regime to govern secured credit. These legal regimes are highly regarded around the world, and countries that have not reformed their secured transactions law often look to the Canadian systems as a model. Despite these successes, some aspects of Canadian secured transactions law are woefully inadequate. Most legal experts identify the relationship between the provincial and territorial secured transactions regimes and the federal *Bank Act* security provisions as the most pressing problem. Banks in Canada may take provincial or territorial security interests in collateral to secure their loans. However, they also have the option of taking a special security device available only to banks. This security device is currently referred to as section 427, *Bank Act* security, although this designation has changed over time with the renumbering of the *Bank Act*.[2] The co-existence of these two secured transactions regimes has produced considerable uncertainty; uncertainty that seriously undermines the efficiency of Canada's secured transactions law.

This Report briefly examines the economic importance of an effective secured transactions regime and traces the evolution of the Canadian secured transactions law. It then examines the particular problems caused by the co-existence of provincial/territorial and federal secured transactions regimes in both the common law jurisdictions, as well as the civil law jurisdiction in Quebec. The Report then identifies fundamental principles to use in assessing the available reform options and, using these principles, critically assesses

the strengths and weaknesses of each reform proposal. The Commission concludes that the *Bank Act* security provisions should be repealed. The Commission believes that repeal is the best way to produce an efficient and less complex legal environment for extending secured credit. It also has the advantage of creating a fairer system; one in which bank and non-bank lenders are treated alike.

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1 See H. Fleisig, "The Power of Collateral" (1996) 33 *Finance and Development* 44.

2 It has previously been designated as section 74, section 88 and section 178 *Bank Act* security. It is presently governed by sections 427 to 429 of the *Bank Act*, S.C. 1991, c. 46.

2. The Importance of Secured Credit

Secured credit is an efficient form of lending under which the borrower gives the lender a special kind of property interest in some or all of the borrower's assets. These assets stand as collateral for the loan. In the event of a default by the borrower, the lender has the right to enforce its security interest by seizing and selling the collateral. By obtaining a security interest, the secured lender also obtains an assurance that it will be paid before most other claimants. This makes the secured lender's loan less risky than it would be if the lender extended unsecured credit to the borrower. This reduced risk is reflected in a lower interest rate for the loan. Since the lender can rely on the value of the collateral, a secured lender may also be willing to lend money in situations for which credit might not otherwise have been extended.

All of the provinces and territories have put into place a modernized secured transactions regime. Although a creditor was able to take a security interest in the debtor's assets under the unreformed law, there were a number of problems which tended to make it more difficult and more expensive to take an effective security interest.[1] The new secured transactions regimes are designed to facilitate secured financing. They do so in three ways. First, they reduce the costs of obtaining and publicizing security interests, thereby reducing the transaction costs of secured credit. Second, the priority rules that govern competitions between the secured party and other claimants who assert an interest in the same asset are rationalized so that outcomes are more transparent and easier to predict. Priority is generally given according to the order of registration in a public registry, which thereby publicizes the existence or potential existence of a security interest to third parties. Third, the statutes provide an efficient mechanism through which the secured party can enforce the security interest against the assets in the event of a default by the debtor.

These legislative reforms clearly place a high value on the efficiency and effectiveness of the institution of secured credit. Indeed, the

Canadian statutes have been used as a model for reform efforts in other countries. Despite this, there is one area of Canadian secured transactions law that is badly in need of reform: the relationship between the provincial and territorial regimes, which govern secured transactions law, and the provisions of the *Bank Act*, which create a federal security interest in the debtor's goods. The co-existence of two different secured transactions regimes introduces a number of legal uncertainties. Legal uncertainty makes it more difficult for lenders to predict outcomes, which in turn undermines the efficient operation of Canada's secured transactions law.

> "Two basic loan transactions have evolved in private markets: unsecured and secured. When a borrower offers an unsecured promise to pay, the lender must rely on the borrower's reputation, or trust that the borrower will pay back the loan in order to have access to future loans. In secured transactions, promises to repay are backed by collateral that lenders can seize and sell in the event loan payments are not made as agreed ... The issue of collateral is one of great economic importance. When borrowers cannot use their assets as collateral for loans and cannot purchase goods on credit using the goods themselves as collateral, interest rates on loans tend to be higher to reflect the risk to lenders."
>
> H. Fleisig, "The Power of Collateral" (1996),
> 33 *Finance and Development* 44.

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1 See J.S. Ziegel, "The Legal Problems of Wholesale Financing of Durable Goods in Canada" (1963) 41 *Canadian Bar Review* 54.

3. The Evolution of Canadian Secured Transactions Law

To understand the evolution of Canadian secured transactions law, both provincially/territorially and federally, one must know something about the federal character of Canada.

Under section 92(16) of the *Constitution Act, 1867*, each province has exclusive power to legislate property matters and civil rights in its jurisdiction. As a result, secured transactions law is primarily a provincial matter. Notwithstanding this, the federal Parliament may legislate secured transactions pursuant to several powers that are enumerated in section 91 of the *Constitution Act, 1867*, including the power over banks and banking. This permits Parliament to create, through legislation, a statutory regime for the creation of a special secured transactions regime that governs security interest granted to banks by their borrowers. When valid provincial or territorial law conflicts with federal law, the federal law has precedence through the doctrine of federal paramountcy.[1] It is within this constitutional framework that the present form of Canadian secured transaction law emerged.

Canadian banking legislation originally restricted banks from taking provincial or territorial security interests in personal property to secure their loans. This was consistent with the then prevalent notion that the credit-granting practices of banks should be limited to short-term extensions of credit. However, because of Canada's emerging economy there was a nearly insatiable need for long-term loans. Parliament responded in 1890 by including statutory provisions in the federal *Bank Act* that permitted banks to secure their loans to a limited class of borrowers by taking a security in specific classes of goods. At first, the security was available only for wholesale manufacturers of goods and wholesale purchasers of primary products. The scope of the legislation was subsequently expanded to include farmers, fishers, aquaculturists and retail sellers. This expansion was largely the result of the lobbying efforts of members of those sectors who wished to use their assets as collateral to secure bank loans.[2]

In 1923, the *Bank Act* provided for the creation of a registry system to alert third parties that a bank had taken a security interest in the borrower's property. Failure by a bank to register rendered the security void against certain subsequent third parties, such as buyers and other secured parties.[3] The *Bank Act* also provided rules that set out the enforcement rights of the secured party upon default, as well as rules governing other aspects of the security.[4]

In 1967, banks were released from the prohibition against taking provincial or territorial security interests in personal property. However, in many respects the *Bank Act* security was a better security device. Provincial and territorial secured transactions law had not been modernized and reformed, leaving a number of difficulties to confront the secured lender. For example, the provincial and territorial registry systems required registration of the actual security document, whereas the *Bank Act* provisions provided a more flexible system under which it was sufficient to register a brief notice in the federal *Bank Act* registry system. At that time, the co-existence of two competing security regimes was not perceived as posing a significant problem. Although people had to undertake multiple registry searches before acquiring an interest in personal property, they simply accepted this inconvenience. Since provincial and territorial secured transactions law had not yet embraced the idea of a single registry system for all security interests, multiple registry searches were considered the norm. Although the situation was more complex in the civil law jurisdiction of Quebec, the resolution of priority competitions in the common law jurisdictions was relatively uncontroversial since basic law principles for common law property were used to determine priorities. The *Bank Act* security introduced a number of innovative features into the law of secured financing, and it was widely acknowledged that these advantages far outweighed the disadvantages of having both provincial/territorial and federal secured transactions regimes.[5]

However, as provinces and territories enacted modern secured transactions regimes, difficulties arose. To a large degree, the modernized provincial and territorial secured transactions regimes were self-contained codes in which the legislation set forth most of the important rules concerning the creation, priority and enforcement of

security interests in personal property. Unfortunately, the co-existence of the *Bank Act* security regime and the modernized provincial and territorial secured transactions regimes has produced problems of extraordinary complexity.

> "It is plain that the task of reconciling section 178 [now section 427] security with *Personal Property Security Act* security interests and all the other competing interests in an increasingly complex area of law will not be promptly accomplished by traditional common law methods. *Bank Act* security was designed for simpler times and primary extractive industries where competing security interests were few. Virtually every court and scholar to investigate the issues in the past decade has commented on the need for federal-provincial co-operation and legislative reform to reconcile the *Bank Act* and the *Personal Property Security Acts*."
>
> B. Crawford, "Must a Bank Comply with Provincial Legislation when Enforcing a *Bank Act* Security Interest: *Bank of Montreal* v. *Hall*" (1991), 70 *Canadian Bar Review* 142 at 156.

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1 *Multiple Access Ltd.* v. *McCutcheon*, [1982] 2 S.C.R. 161; *Tennant* v. *Union Bank of Canada* [1894] A.C. 31; *Bank of Montreal* v. *Hall*, [1990] 1 S.C.R. 121.

2 R.H. Anstie, "The Historical Development of Pledge Lending in Canada" (1967) 74 *Canadian Banker* II, 81.

3 *Bank Act*, s. 427(4)(a).

4 For a more detailed review of these and other aspects of the *Bank Act* security interest, see B. Crawford and J.D. Falconbridge, *Banking and Bills of Exchange*, 8th ed., (Toronto: Canada Law Book, 1986) at 403–62; W.D. Moull, "Security Under Sections 177 and 178 of the *Bank Act*" (1986) 65 *Canadian Bar Review* 242.

5 See R.J. Wood, "The Nature and Definition of Federal Security Interests" (2000) 34 *Canadian Business Law Journal* 65 at 71–3.

4. Problems Caused by the *Bank Act* Security Provisions

Four categories of problems caused by the *Bank Act* security provisions seriously compromise the efficiency and effectiveness of Canadian secured transactions law: statutory obsolescence, competing federal-provincial/territorial priorities, dual registry and pre-emption of provincial/territorial legislative objectives.

a. Statutory Obsolescence

One set of problems arises because the *Bank Act* security provisions date back to 1890. While the security device has undergone a series of amendments, at no time has it been rationalized or modernized to eliminate some of its more archaic features. There are two aspects to the problem of statutory obsolescence. The first is the legal uncertainty that results from the archaic terminology and concepts used in the federal statute. The second is the decreased use of the *Bank Act* security because the federal provisions fail to provide banks with a fully effective and comprehensive security device.

> "During the intervening period of more than 100 years they [the *Bank Act* security provisions] have grown haphazardly, without a coherent plan, and responding to particular judicial decisions or group pressures rather than sound development of commercial law principles. As a result s. 178 [now section 427] and its companion provisions in the latest revision of the *Bank Act* present us with a distressingly uncoordinated and frequently obscure set of clauses whose meaning often defies logical analysis."
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> J.S. Ziegel, "Interaction of Provincial Personal Property Security Legislation and Security Interests under the *Bank Act*" (1986–87), 12 *Canadian Business Law Journal* 73 at 80.

The *Bank Act* provisions are replete with obscure language. For some kinds of collateral, the bank also obtains "a first and preferential lien", but for other types of collateral this status is not conferred.[1] Other examples of obscure language include the provisions that give the security priority over an unpaid seller's lien.[2] Again, there is considerable debate over the effect of these provisions.[3] These controversies add to the legal uncertainty associated with using the *Bank Act* security, since the matter can only be resolved through expensive litigation. When such uncertainty exists, commercial parties are unable to predict outcomes or conduct meaningful risk assessments.

Another problem associated with the obscure language of the federal provisions concerns the "document of title fiction". A bank that is given a *Bank Act* security obtains the same rights and powers as if the bank had acquired a warehouse receipt or bill of lading in which that property was described.[4] In the common law provinces and territories this operates in much the same way as a common law mortgage. There is a transfer of legal title to the bank, but the debtor also retains a proprietary interest in the collateral in the form of a right of redemption. Therefore in common law jurisdictions, the bank's ownership of the collateral does not generally give rise to characterization problems. This is not the case in Quebec. Under the civil law, the concept of ownership is unitary. If the bank is deemed to be the owner, then the debtor cannot also be the owner, but must be regarded as holding the property on the bank's behalf. However, the bank's ownership is restricted; the bank is required to retransfer the

> "... it is my opinion, nevertheless, that the intent of the law was well and truly to effect a genuine transfer of property rights despite the complete incongruity and lack of rationality of such a decision regarding a civil law concept of property rights." [translation]
>
> Justice Baudouin, in *Bérard* v. *Cie Montréal Trust* [1997] A.Q. no. 82 (A.C.A.), par. 66.

property when the obligation is satisfied, and the debtor has the right to retain possession of the property prior to any default. Unfortunately, this approach is completely out of step with the civil law concept of ownership, and introduces a high degree of irrationality and incoherence into the civil law.[5]

In addition to the legal uncertainty created by archaic statutory provisions, there are several features of the *Bank Act* security that make it unsuitable as a lender's primary security device. The *Bank Act* security can only be given to certain classes of debtors on certain classes of the debtor's assets.[6] Unlike provincial or territorial security interests, the *Bank Act* security cannot be granted on all of a business debtor's present and after-acquired personal property. It is also restricted in the types of obligations that it can secure. The *Bank Act* security cannot be given for past indebtedness.[7] The remedial scheme is also less comprehensive because the *Bank Act* provisions do not give the bank the power to appoint a receiver–manager upon default. Because of these limitations, it is uncommon for banks to rely on a *Bank Act* security as their primary security device. Instead, banks predominantly take the *Bank Act* security as a back up, relying on it only if there is a problem with their provincial or territorial security interest. As will be explained, double documentation creates a number of legal difficulties.

b. Competing Federal–Provincial/Territorial Priorities

The most serious problem with the co-existence of two secured transactions regimes is the legal uncertainty that arises when a *Bank Act* security competes with a provincial or territorial security interest. This occurs when a borrower gives the same asset as a *Bank Act* security to a bank and as a provincial or territorial security interest to another creditor. Neither the *Bank Act* nor the provincial or territorial personal property security statutes provide a complete set of priority rules to govern such a competition. This lack of compatibility between the federal and provincial/territorial systems has created a myriad of problems and has produced an intolerable degree of legal uncertainty. Moreover, the nature of the problem and its analysis

differ substantially when the security interest is from a common law jurisdiction or from the civil law jurisdiction of Quebec.

At least four priority problems are caused by this gap in the common law jurisdictions. The first problem concerns the status of an unperfected, or unregistered, provincial or territorial security interest in competition with a *Bank Act* security in the common law jurisdictions. A priority competition between a *Bank Act* security and a provincial or territorial security interest is generally determined according to their order of creation. The *Bank Act* security only attaches to the interest that the debtor has in the property. A prior provincial or territorial security interest therefore has priority over a subsequent *Bank Act* security. The *Bank Act* provides that a *Bank Act* security has priority over any subsequent interest. Therefore, a prior *Bank Act* security has priority over a subsequent provincial or territorial security interest. However, a failure to register a *Bank Act* security will result in its subordination to competing interests. The problem is that a similar loss of priority does not result when it is the provincial or territorial security interest that is not registered or otherwise perfected.[8] This produces a commercially unacceptable

> "It is difficult to escape the conclusion that the federal law governing security interests is in a wretched state of disrepair. Judges and academics alike have critically commented upon the obscure language of the *Bank Act*. Although the progressive development of the case law has made it somewhat easier to predict the outcome of priority competitions between a *Bank Act* security interest and a PPSA [*Personal Property Security Act*] security interest, these outcomes cannot be regarded as commercially acceptable. They violate a central norm of modern personal property security law — that third parties should have some means to discover the existence of a security interest."
>
> R. J. Wood, "The Nature and Definition of Federal Security Interests" (2000) 34 *Canadian Business Law Journal* 65 at 107.

outcome, as there is no means by which a bank can learn of the existence of the unregistered security interest. This particular problem does not arise in the civil law jurisdiction of Quebec, since the hypothecary (secured) creditors' rights do not arise until the publication of the hypothec (security).[9]

The second problem concerns the priority status of provincial or territorial purchase-money security interests. Under the reformed provincial and territorial secured transactions regimes, a secured party can obtain a single security agreement that will automatically cover new property that is acquired by the debtor after the security agreement is signed. So long as the security interest is properly registered, the secured party will obtain priority over any subsequently registered security interests. An exception is made when the subsequent secured party extends credit to permit the debtor to acquire a new asset. This transaction is referred to as a purchase-money security interest. Often the credit is supplied by a seller who reserves a security interest in the goods that are sold to secure the unpaid purchase price. In other situations, the credit is supplied by a lender who advances funds that enable the debtor to acquire the new asset. So long as certain procedural requirements are satisfied, the holder of the purchase-money security interest will be entitled to priority even though it was not the first to register its interest. For this reason, the rule is sometimes said to create a super-priority favouring the purchase-money security interest.

The priority status of a purchase-money security interest is only partially recognized when a provincial or territorial purchase-money security interest comes into competition with a prior *Bank Act* security that covers after-acquired property. If the purchase-money security interest was given by a seller, the purchase-money security interest will have priority over the *Bank Act* security.[10] But if the purchase-money security interest was given by a lender, the bank will be entitled to priority.[11] This creates a hidden trap for the purchase-money lender. Although the lender ordinarily enters into a loan transaction anticipating priority over competing security interests, this expectation can be defeated if the prior security interest is a *Bank Act* security.

The third problem, which is closely related to the second one, concerns production security interests. Provincial or territorial personal property security legislation provides that a security interest in crops given to enable the debtor to produce or harvest the crops has priority over another security interest given in the same collateral. In addition, most provinces and territories provide a similar priority for animals when the credit enables the debtor to acquire food, drugs or hormones for the animals. Although these production security interests are given priority over a prior provincial or territorial security interest in the crops or animals, the situation changes if the prior secured party is a bank which holds a *Bank Act* security. In this case, the production security interest super-priority is not available.[12] Instead, priority is given to the bank on the basis of the usual first-in-time rule of priority. This substantially undercuts the value of the production security interest super-priority and makes it more difficult for agricultural and aquaculture producers to finance the acquisition of production inputs.

The fourth problem concerns the status of a bank's claim to the proceeds of a sale of collateral covered by a *Bank Act* security. Unlike the provincial or territorial personal property security statutes, the *Bank Act* does not extend its security interest to proceeds. Banks typically include in their security agreements a trust proceeds clause that requires the debtor to hold the proceeds in trust for the bank. There is uncertainty over the application of the provincial or territorial statutes to the bank's claim to the proceeds and uncertainty about the priority rules that would govern the outcome of a dispute between the bank's proceeds claim and a secured party who has a provincial or territorial security interest in the same collateral.[13]

A different set of problems arise and a different analysis must be brought to bear if the interest that is in competition with the *Bank Act* security is governed by Quebec law. There are at least three situations in which the lack of compatibility between the federal and provincial systems produce significant legal uncertainty.[14] The first situation concerns the unpaid seller's right of resolution, which allows the seller to annul the contract of sale. The right of resolution

ordinarily reverts the ownership of the property to the seller retroactively. However, there is uncertainty whether this right can be exercised against property that is subject to a *Bank Act* security. The second situation concerns the non-compatibility of the *Bank Act* security provisions when a competition arises with a moveable hypothec. Since the hypothecary creditor's rights are acquired at the time of publication of the hypothec, a *Bank Act* security has priority over a subsequently published hypothec. This undermines the provincial priority rule giving priority to a vendor who publishes the hypothec within fifteen days of the sale. The third situation concerns property that is subsequently acquired by the debtor. Both the *Bank Act* security provisions and the civil code permit a lender to cover after-acquired property. It is unclear how a competition between a hypothecary creditor and a bank can be resolved when both claim such property.

A problem common to Quebec and the common law jurisdictions concerns the practice of double documentation under which a bank is given both a *Bank Act* security and a provincial or territorial interest in the same collateral to secure the same obligation. The issue is whether the bank must choose which interest to rely on, or if it can assert its *Bank Act* security against one party and its provincial or territorial interest against another party. In Quebec, it is argued that the concept of ownership by the bank is such that double documentation is not conceptually possible, but the matter has not yet been tested in the courts. Some cases in common law jurisdictions suggest that the bank must choose one or the other,[15] while other cases suggest that the bank can pick and choose as it sees fit.[16] Saskatchewan is the only common law province that has dealt directly with this issue. The Saskatchewan legislation provides that a security interest in collateral is void to the extent that it secures payment or performance of an obligation that is also secured by a *Bank Act* security.[17] The use of overlapping security agreements therefore results in the non-application of the *Personal Property Security Act* (PPSA) for any collateral on which a bank holds *Bank Act* security.

c. Dual Registry

One of the fundamental changes brought about by the reform of provincial and territorial personal property security law in the common law jurisdictions, was the creation of a single registry system and a single set of registry principles that govern regardless of the particular form of security agreement used. Under the previous law, the provinces and territories had separate registry systems for different types of security agreements. As well, the registry rules which governed such matters as the duration and renewal of the registration and the effect of non-registration often differed depending on the type of security agreement that was used. A single registry system makes it easier for parties to determine if property that they wish to acquire is subject to pre-existing security interest. They no longer have to conduct multiple registry searches; searching a single registry suffices.

The co-existence of the *Bank Act* security regime with the provincial/territorial security regimes frustrates the ideal of a single registry system. A party must search both the provincial/territorial registry system and the federal *Bank Act* registry whenever dealing with the kinds of goods that might be subject to a *Bank Act* security. Multiple searches add an additional layer of costs. Over the past four years, annual search fees collected by the registry are, on average, in excess of one million dollars.[18] Since private search and registration companies conduct many of the registry searches, the fees paid by searching parties are actually considerably higher than this figure.

In addition to the direct costs of conducting additional registry searches, there are other costs associated with a dual registry system. The existence of two registry systems, each governed by their own set of registration rules, increases the chances of legal error. If a searching party does not realize that the collateral may be subject to a *Bank Act* security, they may not search the *Bank Act* registry. Alternatively, a searching party may conduct a search, but choose the wrong registry office.[19] As well, the federal registry places a greater burden on searching parties when there has been a change of name or a transfer of the collateral to another person.

d. The Pre-emption of Provincial/Territorial Legislative Objectives

In several instances, the approach taken by the federal provisions conflicts with the legislative objectives of valid, in force provincial/ territorial legislation. A good example of this phenomenon involves the application of provincial or territorial legislation that restricts the ability of a secured party to enforce a security interest on a default by the debtor.

The *Bank Act* security provisions set out a number of rules that govern the enforcement of the security in the event of default.[20] The bank is given the right to seize and sell the goods. This statutory right is in addition to other contractual rights that may be conferred upon the bank by the security agreement. In exercising these rights, the bank must act honestly and in good faith and must give the debtor reasonable notice of the sale and must deal with the property in a timely and appropriate manner with regard to the nature of the property and the interests of the debtor. The *Bank Act* provisions do not give the bank the right to appoint a receiver–manager, and this deficiency, together with the inability to confer an all-encompassing security interest on all of the debtor's present and after-acquired personal property, explains why a *Bank Act* security is now widely regarded as an inferior security device.

There is, however, one situation in which *Bank Act* security may be seen as providing banks with an advantage that is not available under provincial or territorial law. The provinces and territories impose limitations on the enforcement remedies of secured parties in certain instances. Usually these restrictions relate to secured consumer credit transactions. For example, in some provinces a secured party is prohibited from suing for a deficiency after the collateral is sold pursuant to an enforcement sale. In others, certain types of goods that are needed by the debtor to gain a livelihood are exempt from enforcement. Because the *Bank Act* security cannot be taken to secure a consumer credit transaction, no problem arises in these cases. However, to the extent that the remedies of secured parties are restricted in relation to business or agricultural financing, there exists

a potential for conflict between the federal and provincial/territorial legislative provisions. This conflict is largely limited to Saskatchewan. Saskatchewan has legislatively restricted the enforcement remedies of secured parties in relation to farming operations to a much greater extent than other provinces and territories.

The federal *Bank Act* provisions provide that on default a bank has the right to seize and sell the collateral. The Saskatchewan farm protection statutes prohibit a secured party from enforcing its security interest against the collateral. This constitutes an operational conflict between the federal and provincial statutes. This conflict is resolved by the paramountcy doctrine which gives precedence to the federal statutes and renders the provincial or territorial statute inoperative.[21] This means that the Saskatchewan farm protection legislation operates when a non-bank creditor, such as a credit union, is involved and when a bank chooses to take a provincial security agreement rather than a *Bank Act* security to secure the obligation. However, a

> "It may well be that to subject banks to provincial law would result in their having to live under a more restrictive regime. ... However, it does not follow that this is necessarily objectionable to anyone other except the banks and their shareholders. The purpose of legal regulation is to make sure that a fair and realistic balance is struck between the rights of the borrowers and the rights of lenders. It is up to the elected representatives to determine where that balance should be. If the balance is tilted too heavily in favour of borrowers, lenders have the ultimate power at their disposal: refusal to lend. Should this power be exercised to any great extent, laws will soon be changed to bring a fairer balance, since borrowers will suffer when credit facilities are lost."
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> R.C.C. Cuming, "The Position Paper on Revised *Bank Act* Security: Rehabilitation of Canadian Personal Property Security Law or Curing the Illness by Killing the Patient" (1992) 20 *Canadian Business Law Journal* 336 at 344–5.

bank that takes a *Bank Act* security on the collateral is immune from any provincial limitations on the statutory enforcement remedies.

The federal pre-emption of provincial and territorial legislation undermines the legislative policy objectives in other jurisdictions as well. In Alberta, the legislation curtails the self-help remedies of secured parties and lessors.[22] Any seizure or repossession of personal property by a secured party must be carried out by a properly licensed and bonded civil enforcement bailiff. However, because of federal paramountcy, this restriction does not apply to banks. Therefore, banks can use private bailiffs to effect seizures whereas no other secured party can.[23]

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1 *Bank Act*, s. 427(2)(d).

2 *Bank Act*, s. 428(2).

3 See B. Crawford and J.D. Falconbridge, *Banking and Bills of Exchange*, Vol. 1, 8th ed., (Toronto: Canada Law Book, 1986) at 446–8; J.S. Ziegel, "Interaction of Provincial Personal Property Security Legislation and Security Interests under the *Bank Act*" (1986–87) 12 *Canadian Business Law Journal* 73 at 84–8; R.C.C. Cuming and R.J. Wood, "Compatibility of Federal and Provincial Personal Property Security Law" (1986) 65 *Canadian Bar Review* 267 at 273–4.

4 *Bank Act*, s. 427(2)(c).

5 See R.A. Macdonald, "Security Under Section 178 of the *Bank Act*: A Civil Law Analysis" (1983) 43 *Revue du Barreau* 1008.

6 *Bank Act*, s. 427(1).

7 *Bank Act*, s. 429(1).

8 *Rogerson Lumber Co. Ltd.* v. *Four Seasons Chalet Ltd.* (1980), 113 D.LR. (3d) 671; *Bank of Nova Scotia* v. *International Harvester Credit Corp. of Canada Ltd.* (1990) 74 O.R. (2d) 738 (C.A.).

9 P. Ciotola, *Droit des sûretés*, 3rd éd., (Montréal: Thémis, 1999) at 359.

10 *Kawai Canada Music Ltd.* v. *Encore Music Ltd.* (1993), 10 Alta. L.R. (3d) 105 (C.A.); *YMCF* v. *406248 B.C. Ltd.* (1998), 52 B.C.L.R. (3d) 359 (B.C.S.C.).

11 *Royal Bank of Canada* v. *Moosomin Credit Union*, [2003] S.J. 749 (C.A.).

12 *United Grain Growers Ltd.* v. *Royal Bank of Canada*, [2001] 6 W.W.R. 677 (Sask. C.A.).

13 See R.C.C. Cuming and R.J. Wood, "Compatibility of Federal and Provincial Personal Property Security Law" (1986) 65 *Canadian Bar Review* 267 at 292–301; J.S. Ziegel and D.L. Denomme, *The Ontario Personal Property Security Act: Commentary and Analysis*, 2nd ed., (Markham: Butterworths Canada, 2000) at 52–5.

14 See M. Poirier, "Security under Section 427 of the *Bank Act* and Provincial Law: Interaction, Harmonization and Reform" [unpublished report provided by the author and archived at the Law Commission of Canada] at 94–9.

15 *Kassian* v. *National Bank of Canada*, (1998), 61 Alta. L.R. (3d) 92 (Q.B.).

16 *Bank of Nova Scotia* v. *International Harvester Credit Corp. of Canada Ltd.*, (1990) 74 O.R. (2d) 738 (C.A.).

17 S.S. 1993, c. P-6.2, s. 9(2).

18 *Supra* note 14, Appendix B.

19 Under provincial law, registration of a security interest in goods is generally effected in the location of the collateral (although an exception is made in the case of certain types of highly mobile goods). Under the *Bank Act*, the registration must be effected in the jurisdiction where the debtor is located.

20 *Bank Act*, s. 428(7)–(11).

21 *Bank of Montreal* v. *Hall*, [1990] 1 S.C.R. 121; *Kovlaske* v. *Canadian Imperial Bank of Commerce* (2002), 39 C.B.R. (4th) 43 (Sask. Q.B.).

22 *Civil Enforcement Act*, R.S.A. 2000, c-15, s. 9(3).

23 See *Canadian Imperial Bank of Commerce* v. *Sledz*, [1991] 1 W.W.R. 42 (Alta. Q.B.).

5. Principles for Guiding Reform

The Commission believes that the current law is unacceptable and that reform is required. Before considering the various options for reform, it is desirable to identify the fundamental principles that will be used to assess the benefits and costs of each proposal. One of the overarching principles is that the reform should facilitate the use of secured credit by ensuring that secured transactions law is efficient and effective. This involves two components. The first concerns legal certainty. There must be a greater degree of predictability so that parties who transact with one another can know their legal position in advance without having to establish their rights through expensive and time-consuming litigation. The second element is that the law should be structured so that costs of entering into secured transactions are reduced, since unnecessary costs reduce the credit available to businesses.

The second guiding principle is that any law that is proposed should be compatible with both the common law and the civil law secured transactions regimes. The existing federal provisions are badly

> "Forcing Parliament to choose explicitly is also the best guarantee that the interests in national uniformity of commercial law will be mediated with the interests of regional diversity. ... If Parliament should then decide that these provincial initiatives are contrary to its economic policy relating to bans and bankruptcy, let it then exercise its constitutional jurisdiction to specify in detail the legal regime it wishes to apply. But let it do so on the basis of carefully thought out economic principles, and consciously adopted legal techniques responsive to the bijural character of Canadian private law."
>
> R. A. Macdonald, "Provincial Law and Federal Commercial Law: Is 'Atomic Slipper' a New Beginning?" (1991–92) 7 *Banking & Finance Law Review* 436 at 451.

deficient in that they have introduced concepts that are incompatible with the civil law jurisdiction of Quebec and that are at odds with the modernized personal property security regimes that have been adopted by the common law jurisdictions. It is essential that the reformed law operate effectively in both legal traditions.

The third guiding principle is that the federal law should not interfere with valid provincial or territorial legislative measures that are generally applicable within the provinces and territories unless it is necessary to achieve an identified federal objective. Since the doctrine of federal paramountcy can pre-empt valid provincial law, federal legislation should be designed so that the doctrine of paramountcy will not be invoked unless an identified federal objective cannot otherwise be met.

Principles for Guiding Reform

Principle 1

The problems associated with the co-existence of two legal regimes governing security interests in personal property should be addressed to increase the predictability of outcomes and to ensure that the legal regimes governing secured credit are efficient and effective.

Principle 2

Federal secured transactions law should utilize terminology and concepts that are compatible with both the civil law system of Quebec as well as the common law systems of the other provinces and territories.

Principle 3

Federal secured transactions law should not interfere with valid provincial and territorial legislative measures that are generally applicable within the provinces and territories unless it is necessary to achieve an identified federal objective.

6. Options for Reform

The Commission has identified three possible options for reform. The first would retain the *Bank Act* security system, but introduce amendments that would eliminate some of the problems that have been identified. The second would replace the present *Bank Act* system with a modernized federal personal property security system. The third approach would repeal the *Bank Act* security provisions. Each option will be described with a discussion of its advantages and disadvantages.

> "Canadians are raising some fundamental questions as to which level of government is best able to deal with various aspects of Canadian society. It is time to raise some fundamental questions concerning the regulation of personal property security transactions in Canada. It is not good enough to assume that what was needed 100 years ago or even 20 years ago must be retained. Clearly the country is not served by the retention of two conflicting systems of law that deal with the same subject-matter."
>
> R.C.C. Cuming, "The Position Paper on Revised *Bank Act* Security: Rehabilitation of Canadian Personal Property Security Law or Curing the Illness by Killing the Patient" (1992) 20 *Canadian Business Law Journal* 336 at 355–6.

a. Amend the *Bank Act* Provisions

The first option would retain the *Bank Act* security provisions, but introduce amendments that would eliminate the priority problems that have been identified. Banks would continue to be able to take *Bank Act* security to secure their loans. However, the amendments would introduce priority rules that would provide greater legal certainty and, therefore, more predictable outcomes. When a priority competition

arose between a *Bank Act* security and a provincial or territorial security interest, the outcomes would be more commercially sensible.

Some of the legal uncertainty that plagues this area of the law stems from the archaic terminology employed by the *Bank Act* provisions. Some of this uncertainty could be reduced by eliminating or reformulating some of the statutory provisions. For example, the "document of title fiction" could be abolished. In its place the statute could make it clear that the proprietary interest that is obtained by the bank is in the nature of a security right. The debtor would remain the owner of the collateral, but the bank would obtain an interest that would be characterized as a fixed legal charge in the common law jurisdictions or as an accessory real right under Quebec's civil code. Other provisions that contribute to legal uncertainty, such as the provision that gives the bank a "first and preferential lien" could also be eliminated.

Under this option, it would be necessary to introduce into the *Bank Act* a reformulated set of priority rules which would govern competitions between a *Bank Act* security and a provincial or territorial security interest. This could be accomplished by maintaining the separate federal and provincial/territorial registry systems. A *Bank Act* security would continue to be registered in a federal registry, while provincial or territorial security interests would be registered in the provincial or territorial registry systems.[1] The federal provisions would then be modified so as to provide a first-to-register rule of priority. Although the registration location would differ depending on whether a *Bank Act* or provincial/territorial security interest was involved, priority would be awarded to the first secured party to register its interest. This would solve some of the difficulties experienced under the present law. For example, a *Bank Act* security would no longer be defeated by an unregistered provincial or territorial security interest.

In drafting a federal first-to-register rule of priority, a number of complex design issues would need to be addressed. Many of these issues arise because the federal rule would need to properly interact both with the PPSA in the common law jurisdictions as well as the Civil Code of Quebec. There would also be difficulties in determining which transactions would be governed by the federal first-to-register rule of priority. The PPSA jurisdictions look to the substance of the

transaction to determine if the transaction is a security interest. A similar approach is not adopted in Quebec. Even among the common law jurisdictions, there are differences about which transactions are subject to a registration requirement. For example, true leases and consignments are not required to be registered in Ontario, but registration of such transactions is required in certain cases in the other jurisdictions. Although it is conceivable that these problems might be satisfactorily resolved by an extremely detailed set of priority rules that took into account the different regimes in the provinces and territories, it is likely that the statutory provisions would be extraordinarily complex and difficult to apply.

A further disadvantage of this option is that it would still be necessary for third parties to conduct dual registry searches. A search of both the federal registry and the provincial or territorial registry would be required to determine if the debtor's property is subject to a security interest. Consequently, this option would not reduce the transaction costs of registering and searching in additional registry systems.

b. Create a Federal *Personal Property Security Act*

The second option would be to replace the present *Bank Act* system with a modernized federal personal property security system that incorporates many of the features found in the provincial/territorial systems. This option would mean repealing sections 427 to 429 of the *Bank Act* and enacting a federal *Personal Property Security Act* based on the same language, concepts and structure as provincial or territorial legislation. The priority rules of this new federal statute would be harmonized with provincial and territorial law to provide similar priority rules (i.e., a first-to-register rule of priority, subject to a number of exceptions such as the purchase-money security interest super-priority).

This option would solve some of the priority problems that have been identified. In the common law jurisdictions, it would also reduce some of the existing complexities. Presently, users must understand two fundamentally different personal property security systems. If both the federal and the provincial/territorial systems in the common

law jurisdictions shared the same terminology, concepts and approaches, this complexity would be reduced.

A major weakness of this option is its complete disregard of the principle of bijuralism. Although the civil code system of Quebec incorporates many features found in the personal property security regimes in the common law jurisdictions, it remains a conceptually distinct secured transactions regime. While there are commonalities between these two systems, there are also many profound differences. Imposing a federal personal property security regime in Quebec, which is based on a model used in the common law jurisdictions, would not solve the problems of incoherence that will inevitably arise when the federal and provincial/territorial systems use fundamentally different concepts and principles.

As with the first option, the disadvantage of this alternative is that it still will be necessary for third parties to conduct searches of both the provincial or territorial and federal registries to determine if the debtor's property is subject to a security interest. Indeed, under this option this would become a greater problem. At present, the *Bank Act* security is limited in its availability. Only certain categories of borrowers can grant the security, and only certain categories of goods can be given as collateral. A federal *Personal Property Security Act* would eliminate these restrictions and permit a debtor to grant a federal security interest in all of the debtor's present and after-acquired personal property. This expansion in scope would significantly increase the use of the federal security device, which in turn would increase the number of occasions when a third party would need to conduct multiple searches.

c. Repeal the *Bank Act* Provisions

The third option would eliminate the federal security system by repealing sections 427 to 429 of the *Bank Act*. Banks that wished to take security interests in the personal property of their debtors would do so by taking provincial or territorial security interests.

A major advantage of this option is that it results in a more efficient and less complex legal environment. All of the legal uncertainty

problems associated with the co-existence of both provincial/territorial and federal personal property security systems would be eliminated. This option would also have the important effect of reducing the transaction costs of secured financing by reducing search and registration costs. A third party wishing to acquire an interest in the personal property of another would no longer need to undertake dual searches of both the provincial/territorial and the federal registries to determine if property is encumbered. A buyer or lender would only need to conduct a search of a provincial or territorial registry system.

Another major advantage is that it creates a fairer system. One criticism of the *Bank Act* system is that it creates an uneven playing field that favours banks and disadvantages non-bank credit granting institutions. Banks are able to take both *Bank Act* security and provincial or territorial security interests to secure their loans, while credit unions, small loan companies and other non-bank lenders are able to take only provincial or territorial security interests. This may allow banks to obtain an enhanced priority position over competing non-bank financial institutions.

Repealing the *Bank Act* security provisions would, therefore, produce significant benefits that the other reform options do not achieve. It would

- eliminate legal uncertainty,
- reduce transaction costs, and
- establish equal treatment of institutional lenders.

Are there any disadvantages that would militate against implementing this option? We conclude that although the *Bank Act* security played an important role in the Canadian economy at one time, it no longer serves this purpose. When we examine other justifications for retaining it, we conclude that they are weak and do not justify the continued existence of the *Bank Act* security device.

The original justification for the *Bank Act* security was that it would promote certain identified sectors of the Canadian economy. At one time, banks were not permitted to take provincial or territorial

security interests to secure their loans. This restriction was later removed, but at that time provincial and territorial secured transactions law was in a disordered state and did not provide a fully effective secured transactions regime. This impediment has now been eliminated. In every province and in every territory, a modern secured financing regime has been put into place. Therefore, the original justification for the *Bank Act* security is no longer valid.

It might be argued that repealing the *Bank Act* provisions would result in a loss of a long-standing secured financing regime and that eliminating it would make banks change their lending practices.[2] A review of registration statistics provides convincing evidence that this would not be the case. The number of *Bank Act* registrations effected in Canada is relatively small in comparison with the number of provincial or territorial registrations. Banks are well acquainted with the operation of the provincial/territorial secured transactions regimes and regard the provincial or territorial security agreement as their dominant security device. The *Bank Act* security is viewed merely as a secondary or back-up security device that will be used only if a problem is encountered with the provincial or territorial security interest. It is, therefore, highly unlikely that eliminating the *Bank Act* security provisions would result in any significant change in bank lending practices.

The final argument that might be made for maintaining a separate federal secured transactions regime is that it permits banks to make secured loans in jurisdictions that have restricted the enforcement remedies of secured parties. In particular, it might be argued that eliminating the *Bank Act* security regime would cause banks to reduce the availability of credit to the agricultural sector. To secure their loans, banks would rely on provincial or territorial security interests and would be subject to farm protection legislation that restricts the enforcement remedies of secured parties. The flaw with this argument is that the federal government is constitutionally limited in its ability to formulate a legislative policy that can effectively regulate the credit marketplace. Parliament only has the ability to legislate banks. Pre-empting provincial or territorial legislation will only be effective in relation to banks and not in relation to any non-bank lenders such as caisses

populaires or credit unions. This will simply result in a distortion in the market by conferring a benefit on only one class of lenders. To be effective, the regulation must apply to all financial institutions. Only the provinces and territories have the legislative competence to deal with all market participants engaged in secured lending.

> "There is no valid commercial purpose to be served in keeping a separate secured lending regime only for banks. Even assuming the best possible harmonization and reform scenarios, a separate regime entails considerable cost and unfairness, for which no justification exists. The original justification for the separate regime was to foster the development of the Canadian economy, by providing an incentive to banks to make loans to persons engaged in certain primary industries. In light of the highly effective secured lending regimes that exist in every Canadian jurisdiction, the original justification is no longer relevant. The federal Parliament should vacate the field, as it has better, more efficient ways of implementing federal economic policy"
>
> M. Poirier, "Security under Section 427 of the *Bank Act* and Provincial Law: Interaction, Harmonization and Reform" [unpublished report provided by the author and archived at the Law Commission of Canada].

Legal experts who have studied the matter have similarly concluded that repealing the *Bank Act* security provisions is the best option. Surveys of commercial lawyers indicate that this is their preferred option.[3] On April 7, 1997, the Personal Property Security Law Sub-Committee of the Canadian Bar Association – Ontario made a submission proposing the suspension or repeal of the *Bank Act* security regime.[4] In August 2003, the Secured Transactions Working Group of the Uniform Law Conference of Canada recommended the abolition of the *Bank Act* security provisions,[5] and at the Annual Meeting of the Conference it was resolved that the President of the Uniform Conference of Canada should write the federal ministers of

Justice, Finance and Industry recommending repeal of these provisions. In June 2003, a study paper was prepared for the Department of Justice which also proposed repealing the *Bank Act* security provisions as the preferred option.[6]

The Commission believes that this option best meets the criteria of the three guiding principles. We believe that repealing the *Bank Act* security provisions is most likely to create greater certainty in legal outcomes and a more efficient and effective secured transactions regime. This option is best able to take account of the bijural nature of Canadian commercial law. It is also the option that does not frustrate legitimate legislative measures of general application within the provinces and territories.

Recommendation 1

The Law Commission of Canada recommends that Parliament eliminate the *Bank Act* security regime by repealing sections 427 to 429 of the *Bank Act*.

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1 An alternative to maintaining the separate registry systems would be to eliminate the federal registry system and instead require that the *Bank Act* security be registered in the appropriate provincial registry. Although this would eliminate the problem of dual registrations and dual searches, it would produce its own set of problems. It would be necessary to specify federal choice-of-law rules which specify which registry system and also to govern situations where either the collateral or the debtor moves from one jurisdiction to another.

2 The fact that the *Bank Act* security is a federal security device means that banks are able to use the same forms and the same procedures throughout Canada. A bank is, therefore, able to obtain a security interest that is fully effective throughout Canada. However, the current practice is for banks to routinely take both *Bank Act* security and a provincial security agreement on the same collateral to secure the same obligation. This negates any advantage of having a national registry system.

3 See the Working Group on the Reform of Canadian Secured Transactions, *Reform of the Law of Secured Transactions*, online: <http://www.ulcc.ca/en/poam2/PPSA_Rep_2003_En.pdf> (date accessed: 3 July 2004); M. Poirier,

"Security Under Section 427 of the *Bank Act* and Provincial Law : Interaction, Harmonization and Reform", Appendix A.

4 Canadian Bar Association – National Business Law Section, *Submission of Harmonization of Section 427 of the* Bank Act *and the Provincial Personal Property Security Acts* (Ottawa: Canadian Bar Association, November 1997).

5 Working Group, *supra* note 3.

6 Uniform Law Conference of Canada, Civil Section Minutes – 2003 Fredericton, New Brunswick, online: <http://www.ulcc.ca/en/poam2/index.cfm?sec=2003&sub=2003f> (date accessed: 3 July 2004).

7. Transition

Once the *Bank Act* security provisions were abolished, banks would no longer be able to take a federal *Bank Act* security in collateral. Instead they would need to take provincial security interests in the collateral. Since banks already are well acquainted with the operation of the provincial secured transactions regime, there would be very few problems associated with this transition. However, this would not address the issue of banks that would have taken *Bank Act* security prior to the repeal of the *Bank Act* provisions.

Banks that have existing *Bank Act* security in place to secure their loans should not be disadvantaged by the elimination of the *Bank Act* security regime. Transition rules should be developed that would recognize the validity of the *Bank Act* security for a period of time. Existing *Bank Act* security would remain valid for three years. During this period, priorities and other matters would continue to be governed by the *Bank Act* provisions. After the expiration of the three-year period, the *Bank Act* security would no longer be considered valid. Banks would need to obtain provincial security interests from their debtors if they wished to enjoy the status of a secured party. This would not be onerous, since the banks, in many cases, will have taken provincial security interests in addition to their *Bank Act* security. A bank that had not done so would, nevertheless, be able to take a provincial security interest during this period. The transition rule should specify that if this is done before the transition period expires, the bank's priority status against any competing interests would be preserved.

Recommendation 2

The Law Commission of Canada recommends that Parliament enact transition provisions that would recognize the validity of existing *Bank Act* security for three years. During this period, priorities and other matters would continue to be governed by the *Bank Act* provisions. After the expiration of the three-year period, the security would no longer be considered valid.

During the transition period, banks would be expected to take provincial security interests in the collateral and, provided they did so before the expiration of the three-year period, their priority status would be preserved.

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