NEW DEVELOPMENTS IN SECURITY ON INVENTORY* (A PERSONAL PROPERTY SECURITY ACT)

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A. INTRODUCTION TO THE DRAFT PERSONAL PROPERTY SECURITY ACT

The purpose of this paper is to introduce the Ontario draft Personal Property Security Act which was released in April 1964 for comment and criticism and to discuss certain new developments in security on inventory which will be effected by the Act.[1] Although relatively few provisions refer specifically to inventory, the impact of the Act will be most dramatic in inventory financing and an outline of the Act is a necessary foundation for more detailed discussion of certain aspects.

In his introduction to the printed draft Bill, Mr. Catzman, the Chairman of the drafting committee, sounded the keynote as follows:[2]

> The jungle of our personal property security law has been a century in the making. From seeds planted in Victorian times, the assorted statutes now on our books have grown into a tangled mass, which has survived sporadic pruning and hacking. The urgent need is for a bulldozer to clear away the chaos, and for its replacement by a fresh and modern statute.
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> There is no problem in selecting a model statute. Article IX of the U.S. Uniform Commercial Code, which governs secured transactions in personal property, is a project in law reform of outstanding and proven merit expressly designed for modern business.

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1 Unless otherwise specified, section references are to the draft Bill of *An Act to Make Uniform the Law Regarding Security Interests in Personal Property and Fixtures*, prepared by the Catzman Committee under the aegis of the Attorney General of Ontario and printed and distributed for the purposes of further study and development, April 1964. The short title is *The Personal Property Security Act, 1964*.

2 *Ibid.*, Explanatory Notes.

1. The Uniform Commercial Code

Let me interject a word about the Uniform Commercial Code as a whole. The second section of the Code runs as follows:[3]

> Underlying purposes and policies of this Act are
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> (a) to simplify, clarify and modernize the law governing commercial transactions;
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> (b) to permit the continued expansion of commercial practices through custom, usage and agreement of the parties;
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> (c) to make uniform the law among the various jurisdictions.

These purposes and policies are implemented in a Code divided into ten articles. The first article contains the general provisions one would expect to find, for example, definitions, rules of construction, obligations of good faith; Article II covers the law of sale of goods and supersedes the Sale of Goods Act; Article III covers "commercial paper", that is, negotiable instruments; Article IV covers bank deposits and collections which, in the United States is a matter for regulation by state legislation; Article V covers letters of credit; Article VI, bulk transfers; Article VII, warehouse receipts, bills of lading and other documents of title; and Article VIII, investment securities, namely, stocks, bonds, etc. Article IX is headed "Secured Transactions; Sales of Accounts; Contract Rights and Chattel Paper". There is a tenth Article which provides shortly for the date of implementation of the Code and repeal of statutes and parts of statutes superseded by the Code.

The Code has already been enacted in the District of Columbia and in 29 states, including the most important commercial states with which our economy is closely integrated.[4] Successful operation of the Code in Pennsylvania, where it has been in force for about ten years, and in Massachusetts, where it has been in effect for some six years, stimulated adoption across the country.

The preparation of the Code was begun in 1942 as a joint project of The American Law Institute and the National Conference of Commissioners on Uniform State Laws. Various drafts were considered by joint committees of both organizations and debated by the full membership of each at their respective annual meetings. The original draft was promulgated in 1951 by the

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3 *Uniform Commercial Code, 1962 Official Text with Comments*, published by The American Law Institute and the National Conference of Commissioners on Uniform State Laws, section 1-102(2). All references to the Code (U.C.C.) include references to the relevant comments.

4 See CCH, *Instalment Credit Guide*, for current information (table and map, pp. 4451-2).

Conference and the Institute, with the endorsement of the American Bar Association and has since been revised several times. The "1962 Official Text" embodies the latest revision of the Code. A permanent editorial board has been established and this board reports periodically on matters pertaining to the Code in jurisdictions where it has been enacted and where it is being considered for enactment.[5]

This brief introduction to the Code does little justice to the years of effort, by hundreds of specialists, that have gone into the development of the Code in its present form. Certainly no part of the Code has been given more attention or has required greater consideration than Article IX dealing with secured transactions. It is this part of the Code which the Ontario committee has adapted to suit the needs of business in Ontario and which should prove attractive to other provinces as well.

2. Scope of the Act

In New Brunswick and Ontario terms, the draft Act is concerned principally with the field covered more or less by the Bills of Sale (and Chattel Mortgages) Act, the Conditional Sales Act, the Assignment of Book Debts Act and the Corporation Securities Registration Act. Speaking at the meeting of the New Brunswick Bar a year ago, Dean Carrothers said of the post-war history of the law of picketing: "The product is a marvel of confusion that would not be tolerated in any other area of the law."[6] At once, I protest that the law relating to personal property security takes second place to none if pre-eminence be measured by the degree of confusion. I doubt that any will disagree that the documentation under the statutes which I have mentioned is too formalistic and complicated, that the times and places prescribed for filing and renewal of documents are disorderly and unsystematic, that the Bills of Sale Act and the Conditional Sales Act, which have continued with very little change or modification over the years since they were the newest of Victorian legislation, contemplate schemes that are too restrictive and inflexible to cope with modern financing techniques, that the mobility of chattels and the development of province-wide and nation-wide businesses has rendered the County system of filing unreliable and anachronistic and that priorities between competing security interests are not regulated by any comprehensive or organized plan.[6A] I shall not dwell on the inadequacies of the

5 U.C.C., *1962 Official Text*, pp. 1-9.

6 Carrothers, "Labour Law: Doctrine, Dogma, Fiction and Myth", (1964) 14 U.N.B.L.J. 1 at p. 3.

6A Catzman, "Chattel Security: Order out of Chaos?", (1964) 7 Can. Bar J. 278 at 279.

existing law; rather it is expected that these inadequacies will become all the more evident when viewed in the light of the draft Bill.

Let me say first of all that the hallmark of the Bill is simplicity. Those coming to Article IX of the Uniform Commercial Code and to the Bill for the first time may be inclined to dispute this statement. However, I am sure that all will agree that the proposed scheme is a vast improvement over the chaos of existing legislation. With this introduction, permit me to attempt an outline of the proposed Act and then to go on to emphasize some aspects of the Act as it applies to inventory financing which will be greatly facilitated and which will accordingly see the most dramatic changes in business and legal practices.[7]

3. Five elements of a system of personal property security

The Act reflects the fact that an effective security system involves the following five important concepts:

(a) *Agreement between the parties*

A debtor agrees that a creditor is to have first call on all of the debtor's assets, or a prescribed portion of them, for the satisfaction of the debt. It is basically a simple contract. This is recognized in section 9 of the draft Bill which provides that, subject to the Act or any other Act, "a security agreement is effective according to its terms between the parties to it and against third parties".[8] We are talking about a security created by agreement and not about, for example, something imposed by statute such as a mechanic's lien is imposed even as against the wishes of the owner of the property.[9]

(b) *Evidence of the agreement*

Although formalities are reduced to a minimum, it is generally agreed that there must be satisfactory evidence of the agreement and this is recognized in the Act in section 10 which provides that "a security interest is not enforceable against the debtor or a third party unless, (a) the collateral is in the possession of the secured party; or (b) the debtor has signed a security agreement that contains a description of the collateral and, if the collateral is or

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7 I wish to acknowledge that I have drawn heavily from the transcript of proceedings of the Conference on Personal Property Security Law held at the Osgoode Hall Law School, May 1 and 2, 1964, on the papers prepared for the Conference and on Mr. Catzman's introduction to the draft Act.

8 U.C.C. s. 9-201.

9 *Cf.* s. 3 and 30; U.C.C. s. 9-104, 9-310.

includes fixtures or crops or oil, gas or other minerals to be extracted, or timber to be cut, a description of the land concerned".[10] Since the Act is concerned, basically, with the appearance of ownership afforded by possession, there is no requirement of writing in connection with a security which has been transferred to a creditor (the ordinary common law pledge) but other security agreements must be written to be enforceable, even against the debtor.[11]

(c) *The obligation to be secured*

There can be no security interest[12] until value has been given by a secured party. It is only when value is given to the debtor that his obligation to pay or repay arises and the creditor acquires an interest in collateral to secure payment.

(d) *The collateral*

The debtor must own something or have some rights with respect to which it is meaningful to say that the debtor has given security. Until the debtor owns something, until the collateral comes into existence and the debtor has rights in it, there is nothing which can be the subject matter, in any practical sense, of a security agreement.[13]

(e) *Public notice*

The first four elements create a security interest which may be good between the parties, but there are, of course, other people who are interested in the transaction, for example, creditors and possible purchasers of collateral from the debtor. This leads to the requirement that there be some method by which public notice of the creation of the security interest can be given. Generally speaking, there are two methods by which this can be done, namely, by handing over possession or by filing or registering in some public place. Both these methods of giving notice are recognized by the Act. In the case where possession is given to the creditor, the debtor no longer has the appearance of ownership

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10 U.C.C. s. 9-203.

11 As to the requirement of a written memorandum as a prerequisite to enforcement of a contract, see also U.C.C. 2-201 respecting contracts of sale.

12 Defined by s. 1(w) to mean "an interest in goods, fixtures, documents of title, instruments, securities, chattel papers or intangibles that secure payment or performance of an obligation and includes an interest arising from an assignment of book debts". (Revised s. 1(v) as printed.) The Act, following the Code, adopts neither a "title theory" nor a "lien theory". U.C.C. s. 1-201(37) and the comment to s. 9-101.

13 S. 1(c).

of the personal property in question. Where he retains possession and therefore apparent ownership, notice of the fact that his interest is not all that it may appear is given in the public registry.[14]

4. Attachment

"Attachment" is a term of art employed by the Code and the Act to describe the situation which obtains when the first four elements just mentioned coincide, and that regardless of the order of occurrence. The notion of attachment and the concurrence of those four elements is fundamental to the operation of the scheme.[15] It will be noted that the notion of attachment describes simply what occurs within any of the security devices now in use. Nothing really new has been added except the term "attachment" which conveniently describes the giving of legal life to a security interest.

It should be emphasized that this notion covers every transaction, without regard to its form and without regard to the person who has "title" to the collateral, that in substance creates a security interest, that is, an interest in goods, fixtures, documents of title, instruments, securities, chattel paper or intangibles that secure payment or performance of an obligation and includes an interest arising from an assignment of book debts. It also includes a chattel mortgage, conditional sale, equipment trust, floating charge, pledge, trust deed or trust receipt and an assignment, lease or consignment intended as security.[16] In short, the Act is intended to cover any and all kinds of security arrangements however created and whatever the form of documentation used. Forms now in use may continue to be used under the new statute without change and it is the experience in the American jurisdictions that they are so continued for a period until familiarity with the statute and the simpler forms permitted under it can be developed.

It is expressly provided that a security agreement may cover after-acquired property with certain exceptions relating to crops and consumer goods,[17] and a security agreement may also secure future advances or other value whether or not the advances or other value are given pursuant to commitment.[18] These are particularly important in financing inventory and I shall refer to them later in some detail.

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14 S. 46 as printed (since revised).

15 S. 9, 10, 11, 19; U.C.C. s. 9-201, 9-203, 9-204, 9-303(1).

16 S. 2; U.C.C. s. 9-102.

17 S. 12; U.C.C. s. 9-204(4).

18 S. 13; U.C.C. s. 9-204(5).

5. Perfection

The significance of the fifth element, public notice, needs to be developed. Generally speaking, a security interest may conflict with three other types of claim: (1) a claim by another creditor who has reduced his claim to judgment and seeks to exercise his right as an execution creditor, or one who exercises his rights as a creditor through a trustee in bankruptcy; (2) a claim by another creditor to whom the debtor has purported to give an interest in the security which is the subject matter of the first security agreement; and (3) a claim by a person to whom the collateral has been sold. This leads us to consider the second term of art employed in the statute, the term that describes the rights that a secured party has in collateral as they conflict with the rights of third persons, that is, purchasers, mortgagees or creditors. The term is "perfection". Although a security interest may be perfected in the sense that a creditor has complied with all the provisions of the Act and has thus boosted his position to the highest point that he can attain, it does not follow that his interest is perfect. For one thing, the collateral may not be sufficient to satisfy his claim. For another, even a perfected security interest, for example, a mortgage registered under the Act, may be subordinate to other specified interests, for example, the holder of a prior perfected security interest, the purchaser of inventory in the ordinary course of business and the holder of a lien for materials or services. However, generally speaking, a perfected security interest is effective against creditors, trustees in bankruptcy and subsequent mortgagees of the property subject to the security agreement. Perfection is thus a convenient description for the bundle of rights similar to those enjoyed by a secured party under present law.[19]

6. Priorities

Claims between competing creditors are resolved by a detailed scheme of priorities set out in the Act in sections 30 through 37, which embody sections 9-310 through 9-318 of the Uniform Commercial Code. Except for special situations, the "first to file" rule prevails. Security interests perfected by registration have priority in the order of their being registered; if all competing security interests are not perfected by registration, the order of perfection (by registration or by taking possession) determines priorities; and if no security interest has been perfected then priority is regulated by the order of attachment.[20]

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19 S. 19 to 29; U.C.C. 9-301 to 9-309.

20 S. 33; U.C.C. s. 9-312(5).

7. Central filing

(a) *Past and present chaos*

Lawyers tend, I think, to acquiesce in a system with which they have become familiar and in which they have incidentally invested a good deal of time in learning how it works and making it work. However, I think all will agree that it would be a foolhardy lawyer who gave to his client anything more than a much qualified certificate as to the title to personal property which the client was considering acquiring. The main reason for the difficulty lies in the fact that, in all but a few provinces in Canada, filing or registration of documents which are required to be filed is on a county basis. The difficulty and confusion which results may be sufficiently demonstrated by asking oneself the following questions:

(i) *Do I need to file?*

A few illustrations will suffice. The provisions relating to conditional sales of manufactured goods and household furniture need no special mention.[21] Assignments of specified debts do not fall within the Assignment of Book Debts Act.[22] A chattel lease with an option to purchase must be registered or the lessor otherwise protected under the Conditional Sales Act[23] but a consignment agreement may operate without registration or other formality.[24]

(ii) *Where do I file?*

A chattel mortgage is filed in the place where the goods are situate at the time the mortgage is given.[25] But many goods of high value are mobile. A conditional sale is filed in the County of the residence of the purchaser regardless of the location of the goods.[26] The Assignment of Book Debts Act contains no less than five different rules depending on the nature of the assignor.[27] But all depend on localized filing with reference to counties. Only under the Corporation Securities Registration Act is there provision for central

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21 Conditional Sales Act, Ontario, s. 2(5); equivalent in New Brunswick, s. 3 and 4.

22 Ontario, s. 2; New Brunswick, s. 2.

23 Ontario, s. 2(2); New Brunswick, s. 1(e)(ii).

24 *Langley v. Kahnert* (1905) 36 S.C.R. 397; *Re Alcock Ingram & Co. Ltd.* (1923) 53 O.L.R. 422, [1924] 1 D.L.R. 388.

25 Bills of Sale and Chattel Mortgages Act, Ontario, s. 21; Bills of Sale Act, New Brunswick, s. 6(1).

26 Conditional Sales Act, Ontario, s. 2(1)(b); *cf.* New Brunswick, s. 3(2) and 3(3).

27 Ontario, s. 4; New Brunswick, s. 4.

filing.[28] However, only charges contained in certain instruments are covered by that Act; other charges created by a corporation fall within the, so to speak, ordinary provisions of the Conditional Sales Act, the Bills of Sale Act, etc.

(iii) *What do I file?*

The general requirement is that where filing is required the security agreement or a counterpart or copy of it should be deposited in the Registry. However, various supporting documents such as affidavits of execution and affidavits of bona fides are not the subject of uniform requirements. The typical Conditional Sales Act in Canada requires only that the written evidence containing certain simple details of a conditional sale of goods be filed.[29] The Bills of Sale Act[30] and the Assignment of Book Debts Act[31] require an affidavit by an attesting witness and an affidavit of bona fides by the grantee or assignee. An affidavit of bona fides is similarly required by the Corporation Securities Registration Act[32] and there are various affidavits required in connection with renewal of certain charges.

Some statutes contain fairly generous provisions regarding errors and omissions, namely that, unless the error or omission has actually misled some person, it is to be disregarded. (The rule adopted in the draft Act.)[33] By contrast, the typical judicial approach to the requirements of the Bills of Sale and Chattel Mortgages Acts is to require strict compliance without proof that any person has actually been misled by the error or omission involved. Cases on this point are legion and it requires no elaboration.[34]

(iv) *How do I search?*

This is closely connected with the last two questions. Obviously the greater the proliferation of filing requirements the greater the difficulty of search and certification of title. Furthermore, it is not uncommon for records to be kept in a primitive fashion in bound books or at best on index cards.

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28 Ontario and New Brunswick, s. 3.

29 Ontario, s. 2.

30 Ontario, s. 4.

31 Ontario, s. 3(1).

32 S. 2(2).

33 S. 4; Corporation Securities Registration Act, s. 8.

34 See Houlden, "Attacking the Validity of Bills of Sale and Chattel Mortgages in the Province of Ontario by Trustees in Bankruptcy", (1962) 3 C.B.R. (N.S.) 111.

The names of the grantor or the conditional buyer, as the case may be, may be written consecutively on pages reserved for each letter of the alphabet respectively, the concession being made in some situations where there is a heavy usage of a particular letter that the pages are broken down roughly as follows: Ba to Be on one page, Bf to Bi on another, and so on. Clearly I.B.M., Remington Rand and the other experts on business systems have plenty of challenge and scope!

(b) *The new order*

(i) *Registration and search*

All are agreed, I trust, that the present situation is little short of chaotic. The provisions of Article IX of the Uniform Commercial Code, which have been adopted in the draft Act, are designed to do all that is necessary to achieve public notice of the security interests and agreements involved without unnecessary complication in documentation, method of filing and searching.[35]

The proposed Act sets up a unified system for all types of security devices. It is a province-wide system which combines the convenience of a local registry system with the certainty and ease of search of a central system. American experts who attended the conference at Osgoode Hall last May, drawing on their own experience over many years, were unanimous in their approval of the scheme.

The security agreement may be registered in any local registry office in the Province. If fixtures are involved, registration is required under the applicable Land Registry Act if the protection afforded thereby is sought. Upon registration of a security agreement in the office of the local registrar, a summary of the relevant information from the security agreement will be transmitted by rapid communication system to the central office. The effective time of registration is the moment the summary arrives at the central office. Searches will be requested through the local registry offices and transmitted by means of the same rapid communication system to the central office to enable the issue of a certificate to the party requesting the search. The correctness of the certificate will be guaranteed. The security agreement will be retained at the local office where it was registered and it may be examined there.

35 Part IV.

I understand that a similar system of central filing is in operation in British Columbia, Saskatchewan and Newfoundland and that it works satisfactorily in those provinces. The system can and does work effectively provided that the central registry has the necessary equipment and personnel to provide the service. In Ontario, some have expressed concern about searches in centres relatively remote from Toronto. With modern methods of telecommunication and mechanical and electronic equipment for storing and retrieving information, there should be no difficulty in setting up a system to provide almost instantaneous searches on a province-wide basis. The complexity of the system depends on the volume of registrations.

(ii) *Effect and duration of registration*

Registration constitutes notice of the security agreement, is uniformly effective for a period of three years and may be renewed for further three-year periods by registering a renewal statement. Provision is also made for the registration of assignments, discharges, releases of collateral and amendments. In short, the system is simple and straightforward and its accuracy is guaranteed and insured.

(iii) *Affidavits and other formalities*

The Act departs from the requirements of many statutes that the instrument filed be acknowledged or witnessed or accompanied by affidavits of good faith. Those requirements do not seem to have been successful as a deterrent to fraud; their principal effect has been to penalize good faith mortgagees who have inadvertently failed to comply with the statutory niceties and they have therefore been abandoned in the interest of a simplified and workable filing system. Other statutory provisions exist to deal with fraud, for example, the Fraudulent Conveyances Act, the Assignment and Preferences Act,[36] the Bankruptcy Act, as well as the Criminal Code, and it is thought that those are the exclusively appropriate places for such provisions.

8. Notice filing compared with filing the security agreement

The Uniform Commercial Code[37] adopted the system of "notice filing" which had proved successful under the Uniform

36 The relevant provisions of the Alberta Fraudulent Preferences Act were held *ultra vires* in *A.G. Alberta v. Nash* (1965) 50 W.W.R. 155 (Appellate Division).

37 S. 9-402.

Trust Receipts Act. What is required to be filed under the Code is not, as under Chattel Mortgage and Conditional Sales Acts and under the Ontario draft Act, the security agreement itself, but only a simple notice which may be filed before the security interest attaches or thereafter. The notice itself indicates merely that the secured party who has filed may have a security interest in the collateral described. Inquiry from the parties concerned is necessary to ascertain the complete state of affairs and there is a statutory procedure under which the secured party may be required to make disclosure.[38]

In the United States, notice filing has proved to be of great use in financing transactions involving inventory, accounts and chattel paper since it obviates the necessity of refiling on each of a series of transactions in a continuing arrangement where the collateral changes from day to day. When other types of collateral are involved, the alternative procedure of filing a signed copy of the security agreement may be simpler.[39]

As I have indicated, the proposed Ontario Act requires that the security agreement or counterpart thereof shall be registered. However, the security agreement, to satisfy that section, need only show (a) the full name and address of the debtor; (b) the full name and address of the secured party; (c) a description of the collateral sufficient to identify it; and (d) the signature of the debtor. This will probably cause no difficulty in connection with the typical consumer transaction which is secured by a conditional sale contract or a chattel mortgage, but it may well cause difficulty in financing inventory which I shall discuss at some length a little later.

9. Time for filing

Some concern has been expressed in Ontario about the fact that the Bill as drafted does not limit the time within which a secured party must file in order to perfect his security interest. It would follow from this and from other provisions of the Act that a secured party might purposely refrain from filing his security agreement to avoid giving notice that the debtor had a line of credit outstanding and thus avoid impairing the debtor's possibility of securing other credit. Under the scheme, when a secured creditor files his agreement it is effective and relates back to the time of attachment of the security interest notwithstanding that writs of execution may have been placed in the hands of the sheriff

38 S. 18; U.C.C. s. 9-208.

39 U.C.C. s. 9-402, comment.

in the meantime and that numerous creditors may have advanced credit without security. Of course, it is provided that an unperfected security interest is subordinate to, *inter alia,* a person who, without knowledge of the security interest and before it is perfected, assumes control of the collateral through legal process or a person who represents the creditors of the debtor as assignee for the benefit of creditors, trustee in bankruptcy or receiver.[40]

10. Regulation of rights and remedies between debtor and creditor

(a) *General provisions*

The general principle of freedom of contract is preserved in the Act.[41] However, as noted before, the creditor's rights in the security are not enforceable unless the collateral is in the possession of the secured party or the debtor has signed a security agreement.[42]

Sections 15 through 18 contain general rules applicable to the legal relation between creditor and debtor.

Section 15 states that "where a seller retains a purchase money security interest in goods, *The Sale of Goods Act* governs the conditions and warranties of the seller and any disclaimer, limitation or modification of any such condition or warranty, and the conditions and warranties in a sale agreement shall not be affected by any security agreement". It is submitted that it would be better to omit this section altogether. The equivalent section of the Uniform Commercial Code[43] refers to Article II of the Code, the Sale of Goods article, in which the law relating to sale of goods has been rationalized and modernized. However, the Sale of Goods Act as it stands in New Brunswick and Ontario cannot be said in any real sense to "govern" the items listed in section 15.[44]

Another difficulty is that section 15 states that "the conditions and warranties in a sale agreement shall not be affected by any security agreement". A security agreement is defined to mean "an

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40 S. 20; U.C.C. s. 9-301. The claimant's position is effective from the moment he acquires the status mentioned.

41 S. 9; U.C.C. s. 9-201.

42 S. 10; U.C.C. s. 9-203.

43 S. 9-206(2).

44 The items listed in section 15 are the subject not only of the provisions of the Sale of Goods Act but also of difficult and conflicting case law. See Feltham, *Cases and Material on Sale of Goods and Sales Financing,* section 1.3; Atiyah, *Sale of Goods,* second edition, 1964.

agreement that creates or provides for a security interest".[45] The typical conditional sale agreement falls into this category. Surely section 15 cannot be intended to create a distinction between a sale agreement and a security agreement where there is in fact only one agreement. The Code provides simply that "when a seller retains a purchase-money security interest in goods the Article on Sales (Article 2) governs the sale and any disclaimer, limitation or modification of the seller's warranties".[46] If such a provision is required, the simpler wording of the American Code is to be preferred. In any event, since the general principle of law is that the existing law is not altered except to the extent provided in the new Act,[47] the omission of the section altogether would not likely have any unforeseen results.[48]

The typical conditional sale and chattel mortgage now contains a provision to the effect that, if the mortgagee or conditional seller deems itself or himself insecure, all unpaid instalments on the mortgage or sale and the promissory note used in connection therewith immediately become due and payable at the option of the mortgagee or conditional seller. Much concern has been expressed that this provision is too broad and gives a creditor unnecessary and unfair power to throw his debtor into default. Section 16 of the Act limits the exercise of such power to cases in which the creditor "in good faith believes that the prospect of payments or performance is impaired".[49] Presumably the onus rests upon the creditor to show good faith, although this is nowhere spelled out in the Act.

Section 17 sets out provisions governing the duty of care of the collateral by a secured party in possession of it and also provisions governing his use of the collateral while in his possession.[50]

Section 18 is a fairly extensive provision governing a creditor's obligation to provide a statement of account to a debtor or to any other person interested in the collateral.[51] It expands

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45 S. 1(v).

46 S. 9-206(2).

47 *Cf.* U.C.C. s. 1-103.

48 Rationalization and modernization of the law on sale of goods is long overdue. It is submitted that adoption of Article IX of the Uniform Commercial Code should lead to study and adoption of other articles. Article II on Sale of Goods is a desirable prospect for early consideration.

49 U.C.C. s. 1-208.

50 U.C.C. s. 9-207.

51 U.C.C. s. 9-208.

the requirement with which we are familiar in the Conditional Sales Act.[52]

(b) *Default provisions*

It is the essence of any secured transaction that the secured party will have rights of realization against the collateral when the debtor fails to pay or is otherwise in default. Following the Code, Part V of the proposed Act regulates the rights and remedies of the parties when default has occurred. Here again, the general principle is that there should be freedom of contract.[53] In its phrasing, Part V recognizes this general principle but derogates from it to the extent thought necessary to protect debtors.

No one is concerned about the business debtor who has the economic strength in any transaction to bargain for the rights which he desires and who, for this purpose, can afford legal advice. The large majority of transactions does not involve parties on such even footing. For one reason or another, for example, bargaining strength, time available, etc., a debtor or prospective debtor signs a standard form document which has been carefully tailored by the lender or financier to give him wide power in his relations with his debtor. Many standard form documents now in use attempt to put a debtor almost entirely at the mercy of his creditor should any event occur which triggers default under the agreement. The provisions of Part V are designed to redress the balance to the extent thought necessary to give basic protection to a borrower or debtor. It represents a compromise or balance between the general principle of freedom of contract on the one hand and the social necessity of protecting weaker parties to routine commercial transactions on the other hand.

Part V contains reasonable and straightforward provisions about which there would be very little, if any, dispute. For example, the secured party cannot escape his obligation to conduct the disposition of the collateral in a commercially reasonable manner. He cannot escape the obligation of accounting to the debtor or other persons having interests in the collateral for any surplus which arises on a disposition. The agreement cannot take away a debtor's right to redeem the goods at any time before sale by the creditor and it is expressly provided that a debtor who has built up a substantial equity in consumer goods is protected by the requirement that the seller must dispose of the goods in a commercially reasonable manner so that the debtor will have the

52 Ontario, s. 4; New Brunswick, s. 13.

53 S. 9, 51; U.C.C. s. 9-201, 9-501.

maximum amount available to him after satisfaction of the creditor's just claim. Further, a debtor's right to compensation for loss suffered by reason of a creditor's failure to observe the provisions of Part V is spelled out in section 58.[54] As under the present law, some of the rights of the debtor which accrue to him after default can be waived even though he may not contract out of these rights in the original security agreement.

The keynote of Part V is the notion of "a commercially reasonable manner". The general intention of the provisions relating to default is that the secured party must act in a commercially reasonable manner but, at the same time, that he will not be hampered by arbitrary rules set down in the statute which are not necessary for the protection of the interests of the parties.

It should be noted that Article IX and the draft Act are concerned basically with the security aspect of financing. They do not and are not intended

> to regulate matters of social conscience, such as retail instalment selling practices or disclosure of true interest rates, on the assumption that these are matters of legislative policy that should be appropriately dealt with elsewhere and do not properly belong within the framework of the Act.[55]

B. SECURITY ON INVENTORY

It is an unusual manufacturing or trading business which does not at some time require additional working capital which it desires to raise on the security of its inventory. Inventory has certain special features which make it difficult to take an effective security on it.[56] First of all, there is a continuous series of dealings. A man who buys a car retail probably does not buy another car for several years. Documentation, filing and so on are very simple. In the case of inventory financing, however, the dealer or other debtor is continually in touch with his bank or finance company with a view to obtaining more money to obtain new stock or to pay costs of operation. It is a continuing relation and it is contemplated by the parties, the creditor and the debtor, that advances will be made and repaid on a revolving basis, that is, that the balance outstanding on the account will change from week to week or even from day to day.

The second distinguishing feature of inventory is that it is continually changing. The purpose of the business, whether it be manufacturing, wholesaling or retailing, is to dispose of the goods

54 U.C.C. s. 9-507.

55 Explanatory Notes, third page; U.C.C. s. 9-102, 9-203(2).

56 See Ziegel, "The Wholesale Financing of Durable Goods in Canada", (1963) 41 Can. Bar Rev. 54.

and to manufacture or acquire new stock to be disposed of in turn. Advances made by the financier may not relate directly to the acquisition of any particular item of stock. Certain goods, such as automobiles, are more easily identifiable than are others, such as textiles, spare parts for machinery, and so on, which may be characterized by a large volume of items of relatively small value per item.

A third distinguishing feature of inventory is that it is converted into or exchanged for a variety of "proceeds", namely, cash, a simple contract obligation or debt (an account receivable), chattel paper, such as a conditional sale contract or chattel mortgage, or a trade-in of some sort. The contract obligation may be represented by a promissory note and the proceeds may consist of a combination of any or all of the foregoing.

In the case of a manufacturer's inventory, there will be the special feature that raw materials are processed and transformed into goods of a different character or kind.

The most commonly used technique to secure an advance on inventory are the conditional sale and the chattel mortgage.[57] Generally speaking, a conditional sale is limited in its usefulness to goods which are specifically identifiable and of a high enough value per item to justify separate identification of them. Typically, a trader purchases goods under a conditional sale arrangement whereby it has been previously agreed with both his supplier and a financier that the conditional sale contract will be assigned by the supplier to the financier. Thus, in substance, the trader obtains a loan from the financier and gives as security title to the goods which come into his possession for resale. The same result may be achieved by his obtaining goods by outright purchase from his supplier and transferring title to a financier under a chattel mortgage. The main objection from the practical point of view to the use of the conditional sale technique is the proliferation of documents which results from the necessity to create a separate security agreement for each item or group of items obtained.

The chattel mortgage is somewhat more flexible in some aspects but more rigid in others. Both the Ontario and the New Brunswick Acts recognize that chattel mortgages may be given to

57 A floating charge is also used but is of limited value because of the ease with which it may be defeated. Of course, accounts receivable are also often used as security. Several provisions of the Act apply specifically to accounts receivable financing which is beyond the scope of this paper.

cover after-acquired property.[58] However, each security agreement must be separately evidenced in writing and registered. There are the familiar problems of mobile chattels and the technicalities of the affidavits which are required by the relevant statutes. A mortgage to cover future advances does appear to be permitted under the New Brunswick Act, but the amount to be advanced must be specified.[59] Under the Ontario Act, a future advance clause is limited to a situation in which a mortgagee has agreed to make future advances for the purpose of enabling the borrower to enter into or carry on business with such advances and the time of repayment is no longer than one year from the making of the agreement.[60] The affidavit of the mortgagee must state that the mortgage sets forth the extent and amount of the advances intended to be made.[61]

Various devices are employed currently to secure advances to manufacturers and dealers. These and the legal implications of them could occupy us for some time. The problems are all too evident. Rather than setting off on an excursion into those problems, let me go on to outline the provisions of the draft Act specially relevant to security on inventory.

11. The security agreement and registration under the draft Act

The financier and the dealer must first of all make an agreement setting out their legal relation. The financier will no doubt provide expressly the protection which he thinks he needs. This agreement falls within this single Act regardless of its form and will be filed in a central registry in accordance with Part IV of the Act. As I mentioned earlier, section 44[62] requires only that the "security agreement" set forth at least (a) the full name and address of the debtor; (b) the full name and address of the secured party; (c) a description of the collateral *sufficient to identify it*; and (d) the signature of the debtor. Note that section 44 does require that *"the* security agreement"[63] or a counterpart thereof shall be registered and "security agreement" is defined to mean "an agreement that creates or provides for a security interest".[64]

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58 Ontario, s. 14; New Brunswick, s. 2.

59 S. 9(2). Would stipulation of a ceiling figure satisfy this provision?

60 S. 5.

61 *Ibid.* See Ziegel, *loc. cit.* at p. 64.

62 As printed. The sections in Part IV have been revised and some renumbered.

63 Emphasis added.

64 S. 1(v); 1(v) as printed.

It follows that the agreement itself must be filed and in the ordinary course of business this will include many details not specified in section 44.

Having regard to the peculiarities and particular needs of inventory financing, this provision may result in its being impossible for an inventory financier to file "once and for all" a single document covering his relation with the dealer. If, for example, the dealer acquires automobiles on conditional sale from a manufacturer, each new conditional sale contract identifying each vehicle will have to be filed to satisfy the requirement that any agreement creating a security interest must be filed to protect the secured party. Simplification of paper work or, to put it another way, avoidance of proliferation of paper, is in the interest of financier and dealer and presumably would be reflected in costs to the purchaser. How much simpler it would be to adopt section 9-402 of the Uniform Commercial Code which in turn adopted the system of "notice filing" which had proved successful under the Uniform Trust Receipts Act. What is required to be filed under the Code is not the security agreement itself but only a simple notice or "financing statement" which may be filed before the security interest attaches or thereafter. The notice itself indicates merely that the secured party who has filed may have a security interest in the collateral described. Inquiry from the parties concerned will be necessary to disclose the complete state of affairs. Notice filing has proved in the United States to facilitate financing transactions involving inventory accounts and chattel paper since its obviates the necessity of refiling on each of a series of transactions in a continuing arrangement where the collateral and the amount of advances outstanding change from day to day or week to week. Where other types of collateral are involved, the alternative procedure of filing a signed copy of the security agreement itself may be simpler; a scheme which permits notice filing does not thereby prohibit filing the agreement itself.[65]

We have a useful precedent in Canada for coping with the special problems of inventory financing and that is in section 88 of the Bank Act. Banks in Canada do a great deal of inventory financing under section 88 which makes provision for filing a simple notice rather than the security agreement. It is notable that section 88 was enacted in 1923, ten years before the Uniform Trust Receipts Act was adopted in the United States.

Under section 88(4), the bank need only file with the appropriate provincial office of the Bank of Canada a notice of intention in the form of Schedule K to the Act. Schedule K is a

65 U.C.C. s. 9-402 and comment 2.

very simple form and requires only that the borrower in question "hereby gives notice that it is his intention to give security under the authority of section 88 of the Bank Act to the ..... bank". Section 88(4)(a) requires that the notice of intention be "registered in the appropriate agency not more than three years immediately *before* the security was given". Form K does not require any description of the collateral at all, but this probably has little practical significance because it is the banks' practice, I understand, to take a blanket security wherever security may be taken under section 88 of the Act. Bank Act Schedules C through I, which set out the form of agreement between the banker and debtor with regard to the various kinds of security permitted under section 88, need be delivered only to the bank[66] and the scheme leaves it to any person who desires to deal with the manufacturer, or other section 88 borrower, or to take a security interest on his inventory, for example, to ascertain from the appropriate office of the Bank of Canada whether a notice of intention has been filed and, if so, to ascertain from the bank involved the nature and extent of the security.

Under the draft Act, a financier will probably avoid the necessity of filing separate security agreements by the following technique. A dealer will be required to sign a general financing statement and security agreement. This will be filed. The dealer's supplier will ship on order and invoice only. The financier will pay the supplier the agreed price on presentation of the invoice or some other indication that the goods have been shipped. Thus, the shipment is covered by the blanket security agreement; there is no separate security agreement and therefore nothing which requires registration.

It is also said that it is desirable that the financing statement, or the security agreement which is to be filed, set out the amount of the debt secured.[67] However, there is no way to tell the prospective creditor who does search how much is still outstanding under a security agreement. The security agreement may be a chattel mortgage for $10,000; but $9,000 may already be paid off.

A similar problem exists under present law with regard to future advances. It is the practice of some finance houses in Ontario to attempt to avoid restrictions on future advances by taking from a debtor a comprehensive debenture secured by the property of the debtor and under which bonds are issued by the

66 S. 88(1), last four lines.

67 *Cf.* s. 44(1) as printed. To be registrable and effective, a security agreement need not show the amount of the debt.

debtor to the financier when new advances are made. *The Corporation Securities Registration Act*[68] requires only that the debenture be registered along with the affidavit of bona fides specified in section 2(2). That sub-section does not stipulate that the bonds must be outstanding at the time that the affidavit is sworn or the debenture registered and it is therefore thought possible to give effective security by this device for future advances represented by the bonds. Other companies use a simple debenture expressed to secure an amount which in fact is equal to the credit limit although lesser amounts only may be outstanding from time to time. Additional security is usually taken in the form of an assignment of receivables. In both cases, a search of the corporation securities register tells only that there is a security outstanding but not the amount outstanding under the security agreement.

It is submitted that the only argument of weight in favour of requiring filing of the security agreement in the inventory financing situation is that if it is limited to specified chattels which are readily identifiable or if the amount specified in the agreement is such that a searcher, a prospective creditor, will have no hesitation in advancing credit, he may do so without being in touch with the secured creditor who has previously given notice of his interest by filing.

Another possible difficulty with section 44 as it applies in inventory financing is that the security agreement must contain "a description of the collateral *sufficient to identify it*".[69] It is probably established that a blanket security covering all property of a debtor of a certain type is sufficient[70] but, if the security agreement is to be limited in scope, the description of the collateral may be difficult to construct to satisfy the courts in view of their generally restrictive tendency with regard to compliance by secured financiers with the technicalities of similar acts.[71]

It is said that unsecured or general trade creditors will suffer if it is made easy for a financier to tie up all of a debtor's collateral. If the trade creditor takes the trouble to search, or he has a full credit report, he will find that the financier has a security interest over at least part of the stock of a trader or dealer. If he is concerned about his probable position as an execution creditor or as an unsecured creditor in a bankruptcy, he can take a

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68 S. 2(1).

69 Emphasis added.

70 *Royal Bank of Canada v. MacKenzie* [1932] S.C.R. 524, [1932] 2 D.L.R. 12.

71 See Houlden, *loc. cit.*, footnote 36.

security interest which will be subordinate only to the interest already filed. If his is a purchase money security interest, it will take priority on the new goods.[72] If he chooses not to search or obtain a full credit report before advancing money or supplying goods or services on credit, he can hardly complain if it turns out later that a secured creditor is in ahead of him. I understand that early in the history of the American Code there was much concern that the ease of creating a security interest would cause unsecured credit to dry up. Subsequent experience has proven those fears groundless.

The scheme contemplated by Part IV will probably not give rise to a serious difficulty if there is only one financier. However, if there is more than one financier involved, the needs of the parties in an inventory financing arrangement would probably be better served by a simple form of notice filing. It should be noted in this connection that the Act specifically provides for the filing of amendments to a security agreement.[73]

12. After-acquired property

Provided that the collateral is sufficiently described, an after-acquired property clause in a security agreement covering inventory[74] will take effect according to its terms and will have priority, once it is perfected, against all creditors and subsequent encumbrances, except those that are given a special priority, namely, purchasers in the ordinary course[75] and holders of purchase money security interests.[76] Under existing law, a mortgagee's equitable title to future goods is cut off by a *bona fide* purchaser or subsequent legal mortgage of the goods. The courts have refused to hold that registration constitutes notice of the mortgagee's equitable interest.[77] The draft Act expressly provides that registration "constitutes notice" and, in any event, the specific priority provisions are intended to cover possible conflicts of interest.[78]

13. Future advances

It is intended that complications and restrictions in connection with future advances should be obviated by the provisions of the new Act. The general scheme of priority is set out in section 33

72 S. 32(2) or s. 32(3); U.C.C. s. 9-312(3), 9-312(4).
73 S. 50(1).
74 *Cf.* s. 12 re crops and consumer goods.
75 S. 28(1); U.C.C. s. 9-307.
76 S. 32(2); U.C.C. s. 9-312(3).
77 See Ziegel, *loc. cit.*, p. 64.
78 S. 52, as revised (s. 46 as printed).

which provides that "priority between security interests in the same collateral shall be determined (a) by the order of registration, if the security interests have been perfected by registration; (b) by the order of perfection, unless [all] the security interests have been perfected by registration; or (c) by the order of attachment under sub-section 1 of section 11, if no security interest has been perfected".[79]

The equivalent section of the Code follows several of the American accounts receivable statutes in determining priority by order of filing. The justification for the rule lies in the necessity of protecting the filing system—that is, of allowing the secured party who has first filed to make subsequent advances without each time having, as a condition of protection, to check for filings later than his. However, his protection is not absolute if a later encumbrancer's advances constitute a purchase money security interest,[80] nor is the security effective against purchasers in the ordinary course of business who fall within section 28(1).

The following example illustrates the operation of the paramount rule in Clause (a):[81]

> A files against X on February 1st. B files against X on March 1st. B makes a non-purchase money advance against certain collateral on April 1st. A makes an advance against the same collateral on May 1st. A has priority even though B's advance was made earlier and was perfected when made. It makes no difference whether or not A knew of B's interest when he made his advance.

A second example illustrates the operation of Clause (b):

> A and B make non-purchase money advances against the same collateral. The collateral is in the debtor's possession and neither interest is perfected when the second advance is made. Whichever secured party first perfected his interest (by taking possession of the collateral or by filing) takes priority and it makes no difference whether he knows of the other interest at the time he perfects his own.

Clauses (a) and (b) both lead to this result. It may be regarded as an adoption in this type of situation of the deeply rooted common law idea of a race of diligence among creditors.

Clause (c) adds the rule that, so long as neither of the interests is perfected, the one which first attached (that is, under the advance first made) has priority. It is hard to imagine a situa-

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79 U.C.C. s. 9-312.

80 And s. 32(2) is complied with.

81 Examples taken from comment to U.C.C. s. 9-312.

tion where the case would come into litigation without either A or B having perfected his interest. If neither interest had been perfected at the time of filing of a petition in bankruptcy, neither would be good against the trustee in bankruptcy,[82] nor would unperfected interests be good against an execution creditor who had seized the collateral through legal process,[83] nor would the unperfected security interest be good against transferees of the collateral, whether in the ordinary course of business or not, to the extent that transferee gives value without knowledge of the security interest and before it is perfected.[84]

Other examples explanatory of the basic rules and of certain variations of them are to be found in the comments following section 9-312 of the Official Text of the Code.

14. Proceeds

Section 25(1) provides that "a security interest in collateral that is dealt with so as to give rise to proceeds, (a) continues as to the collateral, unless the secured party expressly or impliedly authorized such dealing *and* (b) *extends to the proceeds*".[85] The term "proceeds" is defined to mean "personal property in any form, or fixtures that is or are derived directly or indirectly from any dealing with collateral or proceeds or that indemnifies or compensates for collateral destroyed or damaged".[86] In the inventory situation, the importance of section 25 is that it enables a secured financier to take a continuous security interest in the dealer's inventory and in the proceeds which arise from the disposal of the inventory. Section 25(2)(b) goes on to provide that "where a security interest in the collateral was a perfected security interest at the time of the dealing . . . the security interest . . . becomes unperfected ten days thereafter unless expressly covered by a security agreement relating to the original collateral that was at the time of dealing perfected by registration but there is no perfected security interest in proceeds that are not identifiable or traceable".[87] Thus, a security interest in the collateral has an automatic extension for a period of ten days after the collateral has been disposed of so as to give rise to proceeds but a secured financier may expressly provide in his security agreement that it

82 S. 20(1)(a)(iii); U.C.C. s. 9-301.

83 S. 20(1)(a)(ii).

84 S. 20(1)(b); U.C.C. s. 9-301(1)(c). *Cf.* s. 28(1); U.C.C. s. 9-307.

85 U.C.C. s. 9-306, emphasis added.

86 S 1(9) revised; U.C.C. s. 9-306(1).

87 Revised since draft Bill printed.

extends to proceeds in which case he has a continuing perfected security interest in the proceeds to the extent that they are identifiable or traceable and subject, of course, to the paramount rights of persons to whom the Act gives priority even over perfected (registered, usually) security interests—see section 28(2)(b) which provides that "a purchaser of chattel paper who takes possession of it in the ordinary course of his business has, to the extent that he gives new value, priority over security interest in it . . . that has attached to proceeds of inventory under section 25, whatever the extent of his knowledge".[88]

If there is now any doubt, the Act, particularly section 25, makes it plain that a perfected security interest in proceeds is effective against creditors, execution creditors and a trustee in bankruptcy. In this connection, reference may be made to the recent decision of the Supreme Court of Canada in *Re Canadian Western Millwork Ltd., Flintoft v. Royal Bank of Canada.*[89] The contest in the case was between a bank holding security under section 88(1)(b) of the Bank Act and a trustee in bankruptcy of the bank's customer (a manufacturer) concerning the ownership of certain uncollected debts owing to the customer at the date of bankruptcy. These debts arose from the sale by the customer of goods covered by the bank's security. The bank's security agreement contained the following terms:[90]

> The proceeds of all sales by the Customer of the property or any part thereof, including, without limiting the generality of the foregoing, cash debts arising from such sales or otherwise, evidences of title, instruments, documents and securities, which the Customer may receive or be entitled to receive in respect thereof, are hereby assigned to the Bank and shall be paid or transferred to the Bank forthwith, and until so paid or transferred shall be held by the Customer in trust for the Bank. Execution by the Customer and acceptance by the Bank of an assignment of book debts or any additional assignment of any of such proceeds shall be deemed to be in furtherance hereof and not an acknowledgment by the Bank of any right or title on the part of the Customer to such book debts or proceeds.

The trustee argued that, notwithstanding the bank's agreement, he was entitled to collect the debts because an assignment of book debts held by the bank covering the same book debts was void for lack of timely registration. The bank argued that the fact that the debts arose from the sale of the goods covered by the

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88 U.C.C. s. 9-308.

89 (1965) 47 D.L.R. (2d) 141; *sub. nom. Flintoft v. Royal Bank of Canada,* [1964] S.C.R. 631.

90 47 D.L.R. (2d) 141 at p. 143.

bank's security gave to the bank a valid security notwithstanding the failure of the assignment of book debts. The court upheld the bank's position.

Mr. Justice Judson delivered the judgment of the Court. The following statements are particularly noteworthy:

> In addition to the creation of the trust, the agreement rejects in advance any suggestion that the bank's right to these accounts will depend upon a valid assignment of book debts. This agreement does no more than set out the terms upon which a bank as holder of s. 88 security permits a customer to sell the property of the bank in the ordinary course of business.[91]
>
> . . . To me the fallacy in the dissenting reasons [in the Manitoba Court of Appeal] is the assumption that there is ownership of the book debts in the bank's customer once the goods have been sold and that the bank can only recover these book debts if it is the assignee of them.[92]
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> . . . When these debts, the proceeds of the sale of the s. 88 security, come into existence, they are subject to the agreement between the bank and the customer. As between these two the customer has nothing to assign to the bank. The actual assignment of book debts which was signed does no more than facilitate collection. Any other assignment, whether general or specific, of these debts by the customer to a third party would fail unless the third party was an innocent purchaser for value without notice.[93]
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> . . . Although the bank's customer does not sell as agent for the bank, he does not sell free of the bank's claim to the proceeds. There is an analogy with the case where goods are consigned to a factor to be sold by him and reduced to money. There has never been any doubt of the right of the owner to trace the money or any other form of property into which the money has been converted: *Underhill's Law of Trusts and Trustees,* 11th ed., p. 561.[94]

Although Judson, J. made particular reference to the fact that under sections 88(2) and 86(2), the bank acquires all the right and title of the customer in the collateral, there is nothing in his judgment which indicates to me that a security agreement drawn broadly enough to subject proceeds to a trust for the benefit of the financier would not have the same effect as between any financier and a trustee in bankruptcy as was given by the Supreme Court of Canada to the bank's security agreement in the *Canadian Western Millwork* decision.[95]

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91 *Ibid.*

92 *Ibid,* p. 144.

93 *Ibid.*

94 *Ibid.*, p. 145.

95 For a discussion of relevant considerations, see Ziegel, *loc. cit.*, particularly pp. 96-115.

Section 9-306 of the Code which deals with proceeds and a secured party's rights on disposal of collateral is rather more complex than section 25 of the Ontario Act. It distinguishes cash proceeds such as money and cheques from non-cash proceeds and specific rules are set out covering the rights of the parties in insolvency proceedings. Such a provision might be beyond the power of a Canadian province.

15. Purchase-money security

I have referred from time to time to "purchase-money security". This is defined to mean "a security interest that is

> (i) taken or reserved by the seller of the collateral to secure payment of all or part of its price, or
>
> (ii) taken by a person who gives value that enables the debtor to acquire rights in or the use of the collateral, if such value is applied to acquire such rights."[96]

Section 20(3) provides that a purchase-money security interest that is registered before or within ten days after the debtor's possession of the collateral commences has priority over (a) the claims of execution creditors who have seized the collateral and trustees in bankruptcy, and (b) transfers not in the ordinary course of business occurring between a security interest's attaching and its being registered.[97] Thus, a person taking a purchase-money security, although his interest is unperfected when the new collateral is acquired with funds which he has provided, may protect his interest, against the specified parties whose interests would otherwise be paramount, by registering within ten days after his debtor acquires possession of the collateral.

Section 32(3) is a parallel provision and runs as follows:

> A purchase-money security interest in collateral or its proceeds, other than inventory, has priority over any other security interest in the same collateral if the purchase-money security interest was perfected at the time the debtor obtained possession of the collateral or within ten days thereafter.[98]

Section 32(2) deals with inventory as follows:

> A purchase-money security interest in inventory or its proceeds has priority over any other security interest in the same collateral,
>
> (a) if the purchase-money security interest was perfected at the time the debtor received possession of the collateral; and

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96 S. 1(r) revised; U.C.C. s. 9-107.

97 U.C.C. s. 9-301(2).

98 U.C.C. s. 9-312(4).

(b) if any secured party whose security interest was actually known to the holder of the purchase-money security interest or who, prior to the registration by the holder of the purchase-money security interest, had registered a security agreement covering the same items or type of inventory, had received notification of the purchase-money security interest before the debtor received possession of the collateral covered by the purchase-money security interest; and

(c) if such notification states that the person giving the notice had or expected to acquire a purchase-money security interest in inventory of the debtor, describing such inventory by item or type.[99]

Thus, a purchase-money security interest that meets the tests of the section takes priority over all other interests, perfected or not, which, in this context, will usually be interests asserted under an after-acquired property clause.

The Catzman committee has revised the printed draft by the addition of the words "or its proceeds" after the word "inventory" in the first phrase of section 32(2) and after the word "collateral" in the first phrase of section 32(3). This is to make plain that a purchase-money security interest in collateral, whether inventory or not, is intended to extend to proceeds of the collateral. Also, the word "actually" has been inserted in Clause (b) of subsection (2).[100]

Under existing law, a conditional seller of inventory to a dealer is protected if he registers under the Conditional Sales Act,[101] or affixes his name and address,[102] subject, of course, to the right of a purchaser from the dealer in the ordinary course of business.[103] The conditional seller's interest is protected in all cases against mortgagees and other creditors. The proposed Act makes it plain that a purchase-money security interest may prevail over an after-acquired property clause regardless of the form of the security agreement. *Quaere* the effect of the *Canadian Western Millwork* decision where the contest is between a bank and a person who asserts a purchase-money security interest (other than as a conditional seller)—could the latter defeat the bank's title acquired under section 88(2)?

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99 U.C.C. s. 9-312(3).

100 See comments to U.C.C. s. 9-312, particularly comment 3, p. 682 of the Official Text.

101 Ontario, s. 2(3); New Brunswick, s. 3.

102 Ontario, s. 2(5); New Brunswick, s. 4.

103 Ontario, s. 2(4); New Brunswick, s. 9.

16. Goods on consignment

One way that a supplier may protect his interest in goods shipped to a dealer against creditors and mortgagees of the dealer is to place the goods in the dealer's hands as agent only. The Factor's Act, if not the general law of agency, may operate to give good title to a person who takes from the dealer by sale, pledge or other disposition of the goods in the ordinary course of the dealer's business, but the consignor's title will be good against a mortgagee, a trustee in bankruptcy and execution creditors.[104] The preceding generalizations have skimmed over several technical difficulties and I do that in order to move quickly to the position under the new Act which rationalizes the relevant law by providing in section 2 that the Act applies to all assignments, leases or consignments intended as security.[105] A consignor, where a consignment arrangement is intended as security, must comply with the registration provisions of the Act to protect himself against conflicting claims which are given priority over unperfected security interests.[106]

Some difficulty might be experienced in ascertaining when a consignment is "intended as security". The term "consignment" has no precise meaning and is used to describe a pure agency arrangement as well as an agreement for "sale or return", not to mention its use in some circumstances to denote the person to whom the goods are shipped whatever his relation to the shipper.

The usual reason for a dealer's buying goods on sale or return is to remove from himself the business risk that he may not succeed in moving the goods. A consignment arrangement with that purpose in mind will not be subject to the filing and other requirements of the Personal Property Security Act. Conflicting claims between consignor, on the one hand, and mortgagees, creditors, execution creditors and a trustee in bankruptcy of the consignee, on the other, will fall to be decided by the existing law under which the consignor's interest is, generally speaking, protected.[107]

It would certainly be simpler if all consignment arrangements were made subject to the Personal Property Security Act. If the purpose of the Act is to give notice to interested parties of the fact that goods in possession of a dealer are subject to a claim

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104 *Langley v. Kahnert*, (1905) 36 S.C.R. 397; *Re Alcock Ingram & Co. Ltd.*, (1923) 53 O.L.R. 422, [1924] 1 D.L.R. 388.

105 U.C.C. s. 9-102, emphasis added.

106 See s. 20.

107 Footnote 104. A different result follows if the goods are sold to a dealer, the supplier agreeing to buy back unsold goods.

by some other person and therefore not available to him as security for advances and not to be taken into account in assessing his credit worthiness, there is force in the suggestion that all consignment arrangements should be made subject to the Act. The Code expressly recognizes this problem and provides that "goods held on sale or return are subject to the claims of the buyer's creditors while the goods are in the buyer's possession"[108] and that "where goods are delivered to a person for sale and such person maintains a place of business at which he deals in goods of the kind involved, under a name other than the name of the person making delivery, then with respect to claims of creditors of the person conducting the business the goods are deemed to be on sale or return".[109] The subsection is applicable even though an agreement purports to reserve title to the person making delivery until payment or resale but it is not applicable if, *inter alia,* he establishes that the person conducting the business is generally known by his creditors to be substantially engaged in selling the goods of others or he files under Article IX. There are other provisions governing the special incidents of sale on approval and sale or return; suffice it to note that Article II of the Uniform Commercial Code has rationalized this area of the law which is particularly unsatisfactory under the Sale of Goods Act as it presently stands. Further, the Code Article on sales, is tailored to harmonize with Article IX on secured transactions.

Pending overhaul of the law on sales, long overdue and not likely to come for some time,[110] the onus of establishing that the consignment is not intended as security and therefore free of the provisions of the Personal Property Security Act should be expressly placed on the consignor. No doubt consignors will register to protect their interest if there is a possibility that the Act may apply.

17. Trust receipts

The trust receipt device has proved useful and practical in facilitating financing of the acquisition of inventory in the United States but has not developed in Canada after its unsuccessful experience in the *Dominion Shipbuilding* case in 1923.[111] In the simplest form of trust receipt financing, a manufacturer or other

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108 U.C.C. s. 2-326(2).

109 U.C.C. s. 2-326(3).

110 It is submitted that this is an appropriate subject for early attention by the Ontario Law Reform Commission.

111 *Re Dominion Shipbuilding and Repair Company Ltd.,* (1923) 53 D.L.R. 485.

supplier ships goods to his customer, a dealer, but sends the bill of lading directly to the financier. The financier pays the manufacturer and turns the bill of lading over to the dealer who signs a promissory note covering the amount of the payment made to the supplier. He also signs a "trust receipt" which provides, basically, that he holds the bill of lading and will hold the goods and proceeds on trust for the financier. Under the Code and the draft Act, this will constitute a security agreement covering the bill of lading, goods and proceeds. Problems of establishing title and whether the arrangement is in substance a chattel mortgage will be eliminated.[112]

18. Consumer goods and purchases in the ordinary course of business

Although most provisions of the draft Act and Article IX of the Code are of general application, the Act, following the Code, distinguishes tangible property from intangible property, and tangible property is further divided into three classifications, namely, consumer goods, inventory and equipment.[113] In addition, there are special rules regarding crops in sections 12(2) and 32(1).[114] Classification of tangible property depends not on its physical characteristics but on its functional use in the hands of its owner. For example, a refrigerator is inventory in the hands of an appliance dealer, it is consumer goods when bought by a private householder for use in his home, it is equipment when bought by a restaurateur for use in his business and when it is traded in by either of the latter two to a dealer it once again becomes inventory in the dealer's hands.

These distinctions are applied in the Act in connection with rules which recognize that the commercial circumstances surrounding the purchase of goods for use as equipment and the purchase of goods for use as inventory are different from those surrounding the purchase of goods for use by a consumer in his household.[115] Section 9-307(2) of the Code provides that "In the case of consumer goods and in the case of farm equipment having an original purchase price in excess of $2,500 (other than fixtures . . .) a buyer takes free of [any] security interest even though perfected if he buys without knowledge of the security interest, for value

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112 S. 24 is the "trust receipt section". *Cf.* U.C.C. s. 9-304.

113 S. 1(j); *Cf.* U.C.C. s. 9-109.

114 Crops are in effect a fourth category of goods. See explanatory notes, fifth and sixth pages. There are also special rules regarding fixtures, perhaps a fifth category. Fixtures are not defined.

115 S. 12(2), 14, 32, 56; U.C.C. s. 9-204(4), 9-206(1), 9-312, 9-505.

and for his own personal family or household purpose or his own farming operations unless prior to the purchase the secured party has filed a financing statement covering such goods". This position has not been adopted in the Ontario Act, but it does adopt section 9-307(1) of the Code and provides in section 28(1) that any "purchaser of goods from a seller who sells the goods in the ordinary course of business takes them free from any security interest therein *given by his seller* even though it is perfected and the purchaser actually knows of it."[116] It follows therefore that goods purchased in the ordinary course of business may continue to be subject to a security interest created by some person other than the seller. Even section 9-307(2) of the Code stops short of giving a consumer complete freedom from security interests—he is only free of them if he meets the test of that section which requires that he buy before a security interest is registered against the goods. Under that section he will not be protected in the following case: A gives a chattel mortgage on his car to financier X who registers the mortgage, A then sells his car or trades it to a dealer, B then buys the car from the dealer. B will be subordinate to the claim of financier X even though he will not find anything in the register if he searches under the name of his seller.[117]

It is intended, to the extent that the points are not covered by the new Act, that the provisions of the Sale of Goods Act relating to sales by a seller with voidable title, etc. shall continue to operate. The Ontario Sale of Goods Act in section 23 expressly provides that the law relating to market overt does not apply to a sale of goods that takes place in Ontario. Perhaps it would be just to alter the law radically and provide simply that any purchaser of consumer goods from a dealer takes free and clear of any encumbrances on the goods, thus leaving the finance industry to bear the risk.

The recent decision of Judge Lang in Ontario in the case of *Rider v. Bank of Montreal*[118] is a good illustration of another aspect of the problem. A used car dealer had mortgaged his inventory to the bank, the arrangement being that, when the dealer sold the car, he would go to the bank and deliver part of the proceeds of the sale. The bank would then hand over the ownership permit to the vehicle in question, which had previously been deposited with

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116 Emphasis added.

117 *Moore v. Smith*, [1951] O.W.N. 481. With regard to automobiles and other valuable durables normally identifiable by serial number, a title registration system could eliminate most, if not all, of the problem.

118 [1965] 1 O.R. 69.

the bank and which the dealer would, in turn, transfer to the purchaser. To the knowledge of the bank, which acquiesced in the practice, the dealer did sell mortgaged cars without making payment to the bank and without obtaining the motor vehicle permit from it. In such cases the dealer usually obtained a duplicate form from the Department of Transport, probably on the basis of a declaration that the original was lost. The dealer sold cars to the three persons, from whom the bank subsequently seized the cars. One of the buyers was seventeen years old. In two cases the purchasers did not receive the motor vehicle registration certificate. It was held that a sale of a motor vehicle in Ontario not accompanied by a transfer of the motor vehicle permit at the time of sale or shortly thereafter is not a sale in the ordinary course of business.[119]

It is also notable that transfers between used car dealers, the so-called wholesale transaction, has also been held in several cases not to be a transfer in the ordinary course of business and consequently the transferee cannot take advantage of provisions such as section 9 of the New Brunswick Conditional Sales Act and section 2(4) of the Ontario Act nor of the term which is implied by law in chattel mortgages of a dealer's inventory that the dealer shall have the right to sell in the ordinary course of business.[120] There is nothing in the draft Act to indicate that this decisional law is not to apply—section 28(1) uses the term "ordinary course of business" without qualification.[121]

C. GENESIS OF THE ONTARIO DRAFT ACT

The draft Act was worked into shape by a committee under the chairmanship of Mr. F. M. Catzman, Q.C., of Toronto, and composed, as I mentioned, of practitioners and professors, with the assistance, in the later stages of the work, of the Legislative Counsel for Ontario. The committee laboured at production for a period of over four years and have continued their work on the bill since its release to the public.

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119 It is submitted, with respect, that His Honour should have focussed attention on the nature of the relation between the seller and buyer and not on the details of the transaction. No evidence is reflected in the report which would indicate that the buyers thought the transactions to be out of the ordinary—surely the "ordinary course of business" of a car dealer is essentially selling cars to individual consumers, whatever else it might include. The English log-book cases, relied on by the learned judge, reflect a different situation.

120 *Insurance and Discount Corp. Ltd. v. Motorville Car Sales* [1953] O.R. 16, [1953] D.L.R. 560; *MacDonald v. Canadian Acceptance Corp. Ltd.* [1955] O.R. 874, [1955] D.L.R. 344.

121 *Cf.* U.C.C. s. 1-201(9).

The committee was originally constituted as a sub-committee of the Ontario Subsection of the Commercial Law Section of the Canadian Bar Association. During the progress of their work, they came under the aegis of the Attorney General of Ontario who approved in principle of the project and encouraged its continuance. A first and incomplete draft of the Bill was submitted to the Attorney General's Advisory Committee on the Administration of Justice in January 1963. The Advisory Committee approved the draft in principle and, in due course, the Legislative Counsel and members of his staff became more deeply involved in the final drafting. It was again submitted to the Advisory Committee early in 1964 and printed and distributed in April 1964 for the purposes of further study and development.

A two-day conference on the Bill, held early in May as part of the Commercial Law Programme of the Osgoode Hall Law School, was the occasion of the Bill's debut. Members of the drafting committee and a number of American experts along with other specialists from the Ontario Bar and the business community discussed the Bill in panel sessions and in seminars over a period of two days at meetings which attracted in all about 250 lawyers and business men.

Following the conference and presentation of the Bill at the Montreal meeting of the Canadian Bar Association, the Catzman Committee, acting on suggestions submitted to it and on its own further consideration, made several changes in the draft, mostly minor. The draft Bill was referred by the Attorney General to the Ontario Law Reform Commission.[122] In the Speech from the Throne, read January 20th, the Government gave notice as follows: "Legislation respecting personal property as security will be introduced for your consideration".[123]

At the Banff meeting of the Canadian Bar Association in 1963, the Commercial Law Section recommended the establishment of a committee to study personal property security law on a national basis with a view to the preparation and implementation of a uniform Act. A committee was established under the chairmanship of the Hon. R. L. Kellock and has held two meetings: the first at Osgoode Hall during the conference last May and the second during the Montreal meeting of the Canadian Bar in September. The national committee is marking time, awaiting developments in Ontario.

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122 Established by *The Ontario Law Reform Commission Act, 1964*, Stat. Ont. 1964, c. 78.

123 Ontario, Votes and Proceedings, January 20, 1965, p. 9.

D. CONCLUDING REMARKS

The foregoing is but a brief introduction to a complex subject. All will agree, I trust, that reform is overdue. My hope is that the draft Act will be enacted in Ontario without delay and that other provinces, after due consideration, will see fit to adopt it —on its own merits and with a view to uniformity. At the same time, I hope there is at least a fair chance that the draft might be implemented by Parliament to apply to institutions subject to federal jurisdiction.[124]

It is submitted that other articles of the Uniform Commercial Code should be high on our list of priorities for study with a view to the rationalization and codification of commercial law. I would urge the introduction, with necessary changes, of at least all those portions of the Commercial Code which are not within the Federal jurisdiction in Canada. Indeed, it seems to me that it would be desirable that the necessary constitutional changes be made to permit the rationalization of commercial law by the introduction of a comprehensive Code regardless of the traditional division of power between the Federal Parliament and Provincial Legislatures. However, since any move to alter the traditional division would have many implications beyond the realm of commercial law, which would undoubtedly delay the introduction of needed reforms, I would be happy to see the provinces introduce the substantive parts of the Code which are within their constitutional jurisdiction, leaving for a later date rationalization of provincial commercial law and those matters which fall within the jurisdiction of the Federal Parliament. It would be a backward step to permit those matters which are now the subject of uniformity through Federal legislation to be diversified by Provincial legislation. Rather, I would strongly recommend that, subject only to necessary local variation, all matters of commercial interest should be uniform throughout at least the common law provinces.

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124 Ziegel and Feltham, "Federal Law and a Uniform Act on Security in Personal Property", (1964) 6 C.B.R. (N.S.) 209.