• TAKING PROCEEDS WITHOUT CAUTION
ONTARIO COURT DETERMINES SECURED LENDERS' ENTITLEMENT TO PROCEEDS OF COLLATERAL •

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In *Bank of Nova Scotia v. IPS Invoice Payment System Corporation*, [2010] O.J. No. 1676, the Ontario Superior Court of Justice recently addressed a novel issue of law: whether under Ontario's *Personal Property Security Act*, R.S.O. 1990, c. P.10 [*PPSA*], the amount secured by a security interest in both collateral and proceeds of the collateral is limited to the amount of the secured debt or to the value of the collateral. In finding that recovery is limited to the value of collateral on the date of dealing, the Court brought Ontario law into conformity with that of the rest of the Canadian provinces and added clarity to secured lending.

FACTS

A company carrying on business as "Blooming Rose" borrowed funds from the Bank of Nova Scotia (the "Bank"). The loan facilities were secured by a General Security Agreement ("GSA") and the Bank's security interest was registered first in time under the Ontario *PPSA*. The GSA provided that all amounts received by Blooming Rose from account debtors would be held in trust for the Bank.

Blooming Rose also signed a factoring agreement with IPS Invoice Payment System Corporation ("IPS") under which Blooming Rose assigned its accounts receivable to IPS with no right of redemption. When IPS registered its interest in the accounts receivable under the *PPSA*, it was aware of the Bank's prior interest and, in particular, that Blooming Rose's accounts receivable were pledged as collateral to the Bank. Notably, the funds that IPS advanced to Blooming Rose in accordance with the factoring arrangement were applied to reduce Blooming Rose's indebtedness with the Bank.

When the Bank subsequently learned of the factoring arrangement between Blooming Rose and IPS, it took certain steps to enforce its security and commenced an action to recover amounts collected by IPS on the factored receivables to the extent of Blooming Rose's indebtedness to the Bank.

IPS conceded that the factoring agreement was subject to the *PPSA* and the prior registration of the Bank's GSA. However, it contended that the Bank was entitled only to the proceeds of the sale of its collateral, the accounts receivable, and that the Bank had received such amounts as a result of the application of amounts paid under the factoring arrangement towards Blooming Rose's obligations to the Bank. IPS contended that the Bank would receive double its entitlement to recovery if it were entitled to claim both the proceeds of the sale of the accounts receivable to IPS and funds collected by IPS on the receivables.

THE COURT'S DECISION

The Court's determination centred on the application of s. 25 of the *PPSA*. Section 25(1) provides:

> Where collateral gives rise to proceeds, the security interest therein,
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> (a) continues as to the collateral, unless the secured party expressly or impliedly authorized the dealing with the collateral free of the secured interest; and
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> (b) extends to the proceeds.

Justice Karakatsanis held that collateral can "give rise" to more than one set of proceeds and that both the monies paid by IPS to Blooming Rose for the receivables and amounts actually collected by IPS on the receivables after it acquired them were "proceeds" within the meaning of the *PPSA* in which the Bank had a security interest. In this regard, she noted that the clear purpose of s. 25 is to maintain security over both collateral and the proceeds of collateral where a secured party does not authorize the dealing of its collateral. Justice Karakatsanis also noted that it would be unfair to limit a secured lender's recovery to the proceeds realized from the sale of receivables pursuant to a factoring agreement given that the value of accounts receivable is always discounted in such arrangements.

Having determined that the Bank had a security interest in both types of proceeds, Karakatsanis J. dealt with the more difficult question of whether the recovery of the proceeds was limited by the amount of the secured debt, or by the value of the collateral. She noted that the interpretation of s. 25 of the *PPSA* had yet to be judicially considered.

In dealing with this novel issue of law, Karakatsanis J. observed that every Canadian province except Ontario has provisions in its legislation governing secured transactions that limit the recovery of a secured lender to the value of the collateral on the date of dealing when the secured party enforces against both the collateral and proceeds. Adopting a purposive approach to the interpretation of the *PPSA*, Karakatsanis J. noted that this type of limitation is not inconsistent with the purpose and scheme of the Act. She identified one purpose of the *PPSA* as facilitating the use of personal property as collateral and increasing certainty and predictability in the enforcement of security interests. She found that as the particular focus of s. 25 was on the collateral and proceeds flowing from dealings with collateral, the section was designed to provide a secured party with access to the proceeds of collateral so as to ensure that any shortfall resulting from unauthorized dealings with the collateral can be remedied.

Justice Karakatsanis concluded that limiting recovery to the value of collateral at the time that it was dealt with strikes a proper balance between the interests of the various parties by giving each the deal they bargained for. She noted that secured transactions commonly involve the granting of collateral whose value exceeds the debt secured. The registration of the secured party's interest under the *PPSA* only limits and defines the lender's right to recovery, not the value of the collateral. While the Bank should not be prejudiced by the unauthorized transfer of its collateral, it should likewise not recover a windfall as a result of the same dealings. She noted that since the Bank only bargained for security over the value of its specific collateral, "it should not be able to convert unsecured debt to secured debt simply because the collateral was dealt with." She thus determined that it was appropriate to read into the Ontario *PPSA* the same limitations expressly contained in its provincial counterparts.

As a result, Karakatsanis J. determined that the Bank was entitled to recover the full face value of the factored invoices, reduced by the amount paid by IPS to Blooming Rose for the receivables under the factoring arrangement and applied towards Blooming Rose's debt to the Bank. In so holding, Karakatsanis J. rejected IPS' argument that the value of the collateral was the amount that IPS actually realized on the receivables it purchased, which was $100,000 less than it paid for them.

IMPLICATIONS FOR LENDERS

The Court's determination that a secured creditor's recovery under the *PPSA* is limited to the value of its collateral on the date of dealing brings Ontario law into conformity with that of the rest of the Canadian provinces. In addition to providing greater certainty and predictability with regard to secured lending in Ontario, the decision also provides secured lenders with some assurance that the value of their security interest will not be weakened on account of certain unauthorized dealings with their collateral.

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• SOME WELCOME RECENT AMENDMENTS TO THE *PPSA* •

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Ontario's *Open for Business Act, 2010,* which came into force on October 25, 2010 [the *Act*], contains a number of noteworthy and welcome amendments to the *Personal Property Security Act* (Ontario), R.S.O. 1990, c. P.10 [the *PPSA*]. These changes: (i) reinstate the inadvertently repealed former s. 46(3), which limited the scope of the collateral in which the secured party can claim a perfected security interest to that found in the optional general collateral description field in the financing statement; (ii) reinstate the exclusion of sale-leaseback transactions from the definition of "purchase-money security interest" ("PMSI"); (iii) extend the time a creditor has to register a non-inventory PMSI from ten to 15 days; and (iv) allow a debtor to require a secured creditor to amend overly broad *PPSA* registrations.