

Chapter 7

The Default Priority Rules

INTRODUCTION

7.1 This chapter deals with the provisions in PPSA Part 2.6 governing priority between security interests. The main provision is s 55, which incorporates a set of rules for disputes involving two or more competing security interests in the same collateral. Section 57 incorporates an additional set of priority rules for cases where one or more of the competing security interests is perfected by control. Section 58 governs priority for future advances; s 59 addresses the problem of circular priorities; and s 60 provides for the voluntary subordination of security interests.

7.2 Section 55 is headed 'default priority rules'. 'Default', in this context, means residual as opposed to primary. The heading's meaning is explained in subs 55(1): s 55 applies in a particular case only if the statute provides no other way of determining priority. Other provisions of the statute enact special priority rules for particular cases and the effect of subs 55(1) is that these special rules apply to the exclusion of the default, or residual, rules in s 55. Examples include the special priority rules in ss 62–64 for purchase money security interests (see Chapter 8), the special priority rules in ss 69–72 for security interests in debt payments, negotiable instruments, chattel paper and negotiable documents of title (see Chapter 10) and the special priority rules in ss 85 and 86 for security interests in crops and livestock (see Chapter 8).

7.3 The s 55 priority rules are default rules in the further sense that, in common with all the PPSA priority rules, they apply only if the parties do not specify a different priority order. In other words, the parties are free to contract around the statutory priority rules and s 60 makes this clear by expressly permitting subordination agreements. 'Default', in this sense, means optional as opposed to mandatory.

THE SECTION 55 PRIORITY RULES

Competing perfected security interests

Introduction

7.4 PPSA subs 55(4) provides that priority between two or more currently perfected security interests in the same collateral is to be determined by the order in which the priority time for each security interest occurs. Subsection 55(5) defines priority time to mean the earliest of the following times:

- (a) the registration time for the collateral;
- (b) the time the secured party, or another person on behalf of the secured party, first perfects the security interest by taking possession or control of the collateral;
- (c) the time the security interest is temporarily perfected, or otherwise perfected, by force of this Act.

Competing security interests perfected by registration

7.5 In a case involving, say, two security interests in the same collateral which are both at all relevant times perfected by registration, the effect of subs 55(4) and (5) is that priority turns on the order of registration.

Example 1. On Date 1, SP1 takes a security interest in all Grantor's present and after-acquired personal property and registers a financing statement. The agreement is in writing but, due to an oversight, Grantor does not sign it. On Date 2, Grantor transfers its present and after-acquired accounts to SP2 who registers a financing statement on the same day. On Date 3, SP1 discovers the oversight in the security agreement and Grantor supplies the missing signature. Grantor defaults against SP1 and SP2 and they both claim Grantor's accounts.

PPSA s 21 makes compliance with the s 20 writing requirements a condition of perfection: see paras 5.1–5.3. This means that SP1's security interest was not perfected until Date 3, when Grantor supplied the missing signature. SP2's security interest was presumably perfected on Date 2. However, according to subs 55(4) and (5), priority turns on the order of registration, not the order of perfection and so SP1 has priority over SP2.

7.6 As discussed in para 6.17 of this text, the first to register priority rule, in combination with the PPSA's system of registration by notice filing, enables a secured party to reserve its priority position before the security agreement is in place.

Example 2. On Date 1, SP1 and Grantor start negotiations for a secured lending agreement and SP1 registers a financing statement. The parties complete their negotiations and execute the agreement on Date 3. In the meantime, on Date 2 Grantor signs a security agreement with SP2 covering the same collateral and SP2 registers on Date 2.

SP1's security interest was not perfected until Date 3, when the parties finalised their security agreement. SP2's security interest was perfected on Date 2. However, applying subs 55(4) and (5), SP1 has priority because it was the first to register its security interest. SP2 could have avoided this result by negotiating a subordination agreement with SP 1 or, alternatively, by using PPSA ss 151 or 178 to have SP1 discharge its registration: see paras 6.41–6.42.

7.7 The first to register rule also facilitates blanket registrations and allows the secured party to reserve its priority position for multiple security agreements involving the same collateral type. Example 3 in Chapter 6, reproduced below, illustrates the point.

Example 3. Grantor is a car dealer. On Date 1, SP1 starts negotiations with Grantor for a security interest in Grantor's new car inventory and registers a financing statement. The financing statement describes the collateral as required by the Act and regulations, that is, it states that the collateral is commercial property and also states that it is motor vehicles. On Date 2, the parties complete their negotiations and execute the security agreement. The security agreement describes the collateral as Grantor's new car inventory. On Date 3, Grantor gives SP2 a security interest in its used car inventory and SP2 registers a financing statement on the same day. On Date 4, SP1 and Grantor enter into a second security agreement, this time for Grantor's used car inventory. Grantor defaults against SP1 and SP2 and they both claim the used car inventory.

PPSA subs 21(4) provides that a single registration may perfect one or more security interests. SP1's Date 1 registration perfects its security interests under both its Date 1 and Date 3 security agreements because the collateral description – commercial property; motor vehicles – covers both the new and used cars. To protect itself, SP2 should have negotiated a subordination

agreement with SP1 or, alternatively, arranged for SP1 to amend its registration by narrowing the collateral description.¹

Security interest perfected by registration v security interest otherwise perfected

7.8 If SP1 has a security interest perfected by registration and SP2 has a competing security interest in the same collateral perfected by possession, priority depends on whether SP1 registered its security interest before SP2 perfected its security interest by taking possession of the collateral, or *vice versa*.

Example 4. SP1 and Grantor are in loan negotiations. On Date 1, Grantor agrees to give SP1 a possessory security interest in her cattle and she leaves the cattle in SP1's possession pending the successful completion of the loan negotiations. On Date 2, Grantor gives a security interest in the cattle to SP2 who registers a financing statement on the same day. On Date 3, SP1 and Grantor conclude their loan agreement.²

SP1 took possession of the collateral on Date 1, but its security interest only became perfected on Date 3, when it concluded its security agreement with Grantor. Which of these dates is the relevant one depends on the meaning of the phrase in subs 55(5) 'perfects the security interest by taking possession ... of the collateral'. The most likely interpretation is that perfection in this context refers to the perfection step (taking possession), not the state of perfection (compliance with all the subs 21(1) perfection requirements).³ On this basis, in Example 4, SP1's priority time is Date 1 and so it has priority over SP2. The corresponding provision in the New Zealand PPSA (s 66) refers to the secured party 'taking possession of the collateral', without any reference to perfection, and this wording leaves no doubt that in a case like Example 4, SP1 would have priority. It is reasonable to suppose that the Australian drafters were attempting to achieve the same result.⁴

7.9 If SP1's security interest is temporarily perfected to start with and SP2 has a competing security interest perfected by registration or possession, priority depends on the time SP1's temporary perfection commenced relative to the time SP2 registered its security interest or took possession of the collateral, as the case may be.

Example 5. Grantor is a clothing manufacturer. On Date 1, Grantor gives SP1 a security interest in 200 men's suits stored in its Melbourne warehouse. On Date 2, Grantor delivers the suits to Carrier for shipment to Grantor's Sydney premises and Carrier issues a bill of lading. At Grantor's request, Carrier forwards the bill of lading to SP1 and SP1 receives it on Date 4. In the meantime, on Date 3, Grantor gives SP2 a security interest in the suits and SP2 registers a financing statement on the same day. Date 4 marks the end of five business days from Date 2. Grantor defaults and SP1 and SP2 both claim the suits.

Applying PPSA subs 22(2), SP1's security interest is temporarily perfected for the five business days from Date 2 to Date 4 and thereafter it is perfected by possession: see para 5.13 of this text.

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1. See paras 6.63–6.65 above on changes to registrations.
 2. Example 4 is adapted from Ronald CC Cuming, Catherine Walsh and Roderick J Wood, *Security Interests in Personal Property*, Irwin Law, Toronto, 2005, at p 311.
 3. On the ambiguity of the word 'perfection' in the PPSA context, see para 5.1.
 4. With the exception of Ontario, the Canadian PPSAs are all the same as the New Zealand PPSA in this respect. For discussion, see above note 2, at pp 310–311.

Applying subs 55(4) and (5), SP1's priority time is Date 2, the date Carrier issued the bill of lading, SP2's priority time is Date 3 and so SP 1 has priority over SP2.

7.10 In Example 5, temporary perfection is SP1's initial method of perfection. More often, though, temporary perfection serves as a bridge between other methods of perfection serving to ensure that the security interest remains continuously perfected.

Example 6. Grantor is a clothing manufacturer. On Date 1, Grantor gives SP1 a security interest in 200 men's suits stored in its Melbourne warehouse. On Date 2, Grantor delivers the suits to Carrier for shipment to Grantor's Sydney premises and Carrier issues a bill of lading. SP1 takes possession of the bill of lading on the same day. On Date 4, Grantor negotiates the sale of the suits to a Sydney retailer and SP1 returns the bill of lading to Grantor so that Grantor can take delivery of the suits from Carrier. On Date 5, SP1 registers a financing statement. Date 5 marks the end of five business days after Date 4. In the meantime, on Date 3 Grantor gives SP2 a security interest in the suits and SP2 registers a financing statement on the same day. Grantor defaults and SP1 and SP2 both claim the suits.

SP1's security interest is initially perfected by possession on Date 2 when it takes possession of the bill of lading. Applying PPSA s 35, it is temporarily perfected from Date 4 to Date 5, and it is perfected by registration thereafter. Since there is no break in perfection, SP1's security interest is continuously perfected from Date 2, notwithstanding the changes in the method of perfection, and so its priority time is Date 2: see paras 5.14 and 5.41–5.42 of this text. SP2's priority time is Date 3 and so SP1 has priority over SP2.

Reperfected security interests

7.11 PPSA subs 55(6) provides that a time is a priority time for a security interest only if the security interest remains continuously perfected. Section 56 provides that a security interest is continuously perfected if it remains perfected at all times even if there are changes in the method of perfection. Example 6, above, is a case in point. Example 7, below, is a variation on the facts of Example 6.

Example 7. Grantor is a clothing manufacturer. On Date 1, Grantor gives SP1 a security interest in 200 men's suits stored in its Melbourne warehouse. On Date 2, Grantor delivers the suits to Carrier for shipment to Grantor's Sydney premises and Carrier issues a bill of lading. SP1 takes possession of the bill of lading on the same day. On Date 4, Grantor negotiates the sale of the suits to a Sydney retailer and SP1 returns the bill of lading to Grantor so that Grantor can take delivery of the suits from Carrier. Date 5 marks the end of five business days after Date 4. On Date 7 SP1 registers a financing statement.

The difference between Examples 6 and 7 is that in Example 7, SP1 does not register a financing statement until after the expiration of the s 35 grace period. Consequently, SP1's security interest is unperfected between Date 5 and Date 7. Assume SP2 takes a security interest in the suits and registers a financing statement on Date 6. Applying subs 55(6), SP1's priority time is Date 7 and, since SP2's priority time is Date 6, SP2 has priority over SP1. Now assume that SP2 acquires its security interest and registers on Date 3. At this point, SP1's security interest is perfected by possession of the bill of lading. Nevertheless, applying subs 55(6), SP1's priority time is still Date 7;

SP1 cannot claim that its priority time is Date 2 because its security interest did not remain continuously perfected after Date 2. A similar rule applies in the other PPSA jurisdictions.⁵

7.12 Example 8. Grantor is a clothing manufacturer. On Date 1 Grantor gives SP1 a security interest in 200 men's suits stored in its Melbourne warehouse and SP1 registers a financing statement on the same day. On Date 2, Grantor gives SP2 a competing security interest in the same suits and registers a financing statement. On Date 3, SP1's registration is accidentally discharged due to a clerical error. On Date 5, SP1 discovers the mistake and renews its registration. Grantor defaults and SP1 and SP2 both claim the suits.

Applying PPSA subs 55(6), the result is the same as in Example 7: because SP1's security interest was not continuously perfected after Date 1, its priority time is Date 5, not Date 1. SP2, therefore, has priority over SP1 even though SP1's security interest was perfected by registration at the time of SP2's transaction with Grantor. The Canadian PPSAs make a concession to SP1 in cases like Example 8. Saskatchewan PPSA s 35(7) applies where a registration lapses due to non-renewal or is discharged without authorisation or in error and it preserves the secured party's priority provided it renews its registration within 30 days.⁶ Such concessions can create circular priorities problems and this may be why the Australian lawmakers decided not to toe the Canadian line.⁷

Perfected security interest v unperfected security interest

7.13 Subsection 55(3) provides that a perfected security interest has priority over an unperfected security interest in the same collateral. Subsection 55(3) is discussed in paras 5.47–5.48 of this text.

Competing unperfected security interests

7.14 Subsection 55(2) provides that priority between unperfected security interests in the same collateral is to be determined by the order of attachment of the security interests.

Example 9. On Date 1 SP1 takes a security interest in all Grantor's present and after-acquired personal property and registers a financing statement on the same day. On Date 2, SP2 takes a security interest in Grantor's racehorse and registers a financing statement on the same day. Grantor later defaults and SP1 and SP2 both claim the race horse. Their dispute ends up in litigation and the court finds that both parties misstated Grantor's details in their financing statements and so their registrations are invalid.⁸

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5. See New Zealand PPSA s 66(b), providing for 'priority between perfected security interests in the same collateral (*where perfection has been continuous*)' (emphasis added); and, for example, Saskatchewan PPSA s 35.
 6. The same rule applies in the other Canadian provinces. In Ontario, the concession is not subject to the 30-day registration renewal proviso and it applies in a wider range of circumstances than the Saskatchewan version: OPPSA s 30(6). For discussion, see above note 2, at pp 363–368.
 7. For example, assume that SP3 takes a security interest in the suits and registers a financing statement on Date 4. Applying Saskatchewan PPSA s 35: (1) SP1 has priority over SP2 (providing SP1 renewed its registration within 30 days); (2) SP2 has priority over SP3 (because it was the first to register); and (3) SP3 has priority over SP1 (because SP1's security interest was unperfected on Date 4 when SP3 appeared on the scene).
 8. See paras 6.51–6.62.

Since both registrations are invalid, Example 9 involves a competition between two unperfected security interests and so priority depends on the order of attachment. On the facts, it seems that SP1's security interest attached on Date 1 and so SP1 has priority.

7.15 Example 10. On Date 1, SP1 takes a security interest in all Grantor's present and after-acquired personal property and registers a financing statement on the same day. On Date 2, SP2 takes a security interest in all Grantor's present and after-acquired accounts and registers a financing statement on the same day. On Date 3, Grantor sells goods to Customer on 90-day terms. Grantor later defaults and SP1 and SP2 both claim Customer's account. Their dispute ends up in litigation and the court finds that both parties misstated Grantor's details in their financing statements and so their registrations are invalid.

As in Example 9, Example 10 involves a competition between two unperfected security interests and PPSA subs 55(2) suggests that priority depends on the order of attachment. In Example 10, however, the security interests attached simultaneously on Date 3, which was when Grantor acquired rights in the collateral: see paras 4.14–4.22. The PPSA does not have a rule for cases like this and so the courts will be forced back to common law principles and, at common law, priority turns on the respective dates of the security agreements.⁹

7.16 In most cases involving a competition between unperfected security interests, at least one of the secured parties will realise sooner or later that its security interest is unperfected and it will register a financing statement or otherwise perfect its security interest. If one of the secured parties perfects but the other does not, the dispute will be governed by PPSA subs 55(3), while if both secured parties perfect, the priority rules in subs 55(4) and (5) will apply.¹⁰ At what point does it become too late for a secured party to perfect its security interest? In *Sperry v Canadian Imperial Bank of Commerce* (1985) 17 DLR (4th) 236 (ONCA), SP1 and SP2 held competing unperfected security interests in the debtor's (grantor's) farm equipment. The debtor defaulted and SP1 appointed a receiver. Eleven days later, SP2 registered a financing statement. SP2 argued that its perfected security interest had priority over SP1's unperfected security interest. The court rejected the argument, holding that the priority issue should be resolved by reference to the time at which the security interests came into conflict. This occurred when SP1 enforced its security interest by appointing the receiver. The *Sperry* case has been followed in a number of other Canadian decisions and also in New Zealand.¹¹ Applying the *Sperry* ruling to the facts of Examples 9 and 10, the relevant date is the date on which either SP1 or SP2 claims the collateral, depending on which of them acts first.

The irrelevance of notice

7.17 Pre-PPSA, Corporations Act 2001 (Cth) Chapter 2K provided for the registration of company charges and enacted rules to determine priorities between competing registrable

9. See Louise Gullifer (ed), *Goode on Legal Problems of Credit and Security*, 4th ed, Sweet & Maxwell, London, 2009, at p 74 quoted with approval in *Royal Bank of Canada v RADIUS Credit Union Ltd* [2010] 3 SCR 38 at para [20]; see above note 2, at p 312, also cited in the *Royal Bank* case.

10. Assuming neither security interest is a purchase money security interest: see Chapter 8.

11. See, for example, *John Deere Credit Inc v Standard Oilfield Services Inc* (2000) 16 CBR (4th) 227 (ABQB); *Gibston Downs Wines Limited and RFD Finance No 2 Limited v Perpetual Trust Limited* [2012] NZHC 1022. For a different view, see above note 2, at pp 362–363 arguing that the point of no return is not reached until one of the parties has realised on the collateral and is ready to distribute the proceeds. However, the trend of the authorities is against this view.

charges. The main priority rules were in s 280, which provided that a registered charge (A) had priority over a subsequently registered charge or an unregistered charge (B), but not if charge B was created first and the B chargee proved that the A chargee had notice of the B charge at the time the A charge was created. By contrast, notice is not a factor in the PPSA s 55 priority rules.

Example 11. On Date 1, SP1 makes a loan to Grantor and takes a security interest in Grantor's fleet of trucks but does not register a financing statement or otherwise perfect its security interest. On Date 2, having previously learned from Grantor about SP1's security interest, SP2 takes a competing security interest in the same collateral and registers a financing statement. On Date 3, SP1 registers a financing statement. Grantor defaults and SP1 and SP2 both claim the trucks.¹²

The governing provision is PPSA subs 55(4): SP2 was the first to register and so it has priority over SP1 even though SP2 knew about SP1's security interest at the time of its transaction with Grantor. If SP1 had not registered a financing statement on Date 3, the governing provision would have been PPSA subs 55(3) (a perfected security interest has priority over an unperfected security interest in the same collateral) and, again, SP2 would have had priority even though it knew about SP1's security interest at the relevant time.¹³

7.18 In the *Robert Simpson* case, on which Example 11 is loosely based, SP1 argued that the purpose of the registration requirement is to protect competing claimants against hidden security interests. Since SP2 knew about SP1's security interest anyway, it was not prejudiced by SP1's failure to register and it would be unfair to penalise SP1 by subordinating its security interest to SP2. The court rejected the argument on the simple ground that the statutory priority rule made no reference to the parties' knowledge and there was no basis for reading in a knowledge limitation. *Fairbanx Corporation v RBC* (2010) 319 DLR (4th) 618 (ONCA), discussed in paras 6.55–6.56 of this text, raises a similar issue in the registration error context, and the court's response in *Fairbanx* is consistent with the *Robert Simpson* case. In *Fairbanx*, Fairbanx and the bank held competing security interests in the debtor's (grantor's) accounts. They had both registered financing statements, but Fairbanx's financing statement misstated the debtor's name and so the registration was apparently invalid under Ontario PPSA s 46(6) (the misleading error provision).¹⁴ Fairbanx argued that the error did not prejudice the bank because the bank knew about Fairbanx's security interest anyway and therefore the court should excuse the error. The court rejected the argument, holding that s 46(4) requires an objective assessment: the question was whether the error would be likely to mislead a reasonable person, not whether it actually misled a competing secured party or anyone else. In other words, a competing secured party's knowledge is irrelevant in the context of the misleading error provision, just as it is irrelevant in the context of the PPSA default priority rules.¹⁵

7.19 The main policy justification for the PPSA s 55 approach is that inquiries into knowledge are expensive and time-consuming.¹⁶ On the other hand, a bright-line priority rule, which turns solely on the order of registration or the order of perfection, as the case may be, saves litigation

12. Neither security interest is a purchase money security interest. For discussion of the special priority rules governing purchase money security interests, see Chapter 8 of this text.

13. See, for example, *The Robert Simpson Company Limited v Shadlock and Duggan* (1981) 31 OR (2d) 612 (ONSC).

14. Compare Australian PPSA ss 164 and 165.

15. See also *Stevenson v GMAC Leaseco* (2003) 227 DLR (4th) 154 (NBCA) at paras [20]–[26].

16. See *Shallcross v Community State Banks Trust Co* 434 A 2d 671 (NJ Sup Ct 1981).

costs by keeping the inquiry simple and it facilitates settlements by increasing the predictability of litigation outcomes.¹⁷ A secondary consideration is that introducing a knowledge factor into priority disputes creates the potential for circular priority problems.

Example 12. Pre-PPSA, SP1, SP2 and SP3 each acquire registrable charges, in that order, over Grantor's fleet of trucks. SP1 fails to register its charge, while SP2 and SP3 both register their charges. SP2 acquired its charge with actual knowledge of SP1's unregistered charge, but SP3 knew nothing about it. Grantor defaults against all three lenders and they each claim the trucks.

Applying Corporations Act s 280, SP1 has priority over SP2 because SP2's interest arose later in time and SP2 had actual knowledge of SP1's charge. SP2 has priority over SP3, because SP2 was the first to register. And SP3 has priority over SP1 because SP1 failed to register and SP3 had no knowledge of SP1's charge.¹⁸ The PPSA, s 55 approach avoids this type of issue.

7.20 Returning to Example 11, it might be argued that SP2 is guilty of bad faith or unconscionable conduct. However, this presupposes that SP2 is under an obligation to disclose to SP1 the fact that SP1 has neglected to register a financing statement and it is hard to see what the justification for such a duty might be. In particular, it cannot be said that, by failing to make disclosure, SP2 takes SP1 by surprise because SP1 — like SP2 itself and, for that matter, all register users — must be taken to know the law, including the consequences of failure to register. In any event, imposing a duty of disclosure on SP2 would probably not encourage SP2 to reveal the information to SP1; it is more likely to drive SP2 away. In that event, SP1 may end up losing priority anyway: if Grantor contracts with SP3 instead and SP3 lacks knowledge of SP1's security interest, SP3 will have priority over SP1.¹⁹ In this connection it is worth noting that, with the exception of Ontario, all the Canadian PPSAs require parties to act in good faith and the provision goes on to say that a person does not act in bad faith simply because she acts with knowledge of the interest of some other person.²⁰ There is no corresponding provision in the Australian PPSA, but on general principles the courts should arrive at the same conclusion.²¹

THE SECTION 57 PRIORITY RULES

7.21 PPSA s 57 enacts special priority rules for a competition between security interests one or more of which is perfected by control. Section 57 takes precedence over the other provisions of Part 2.6, including s 55.²² Subsection 57(1) provides that a security interest perfected by control has priority over a competing security interest that is perfected by another means.²³ So, for example, if SP1 has a security interest in all Grantor's present and after-acquired personal property perfected by registration and SP2 later acquires a competing security interest in Grantor's shares perfected by control, SP2 has priority even though SP1 registered its security interest before SP2 acquired control. In its application to a security interest held by an ADI in an ADI account, s 57 represents

17. See Douglas G Baird and Thomas H Jackson, 'Information, Uncertainty and the Transfer of Property' (1984) 13 *Journal of Legal Studies* 299 at pp 312–316.

18. See above note 16, at pp 312–316.

19. See above note 16, at pp 312–316.

20. See, for example, Saskatchewan PPSA subss 65(3) and (4).

21. PPSA s 111 requires parties to act honestly and in a commercially reasonable manner, but the provision only applies to Chapter 4 of the statute (Enforcement of security interests).

22. PPSA subs 57(3).

23. See paras 5.22–5.37 for discussion of the various methods of acquiring control.

a generous concession in favour of the banking industry: see paras 5.23–5.24. The Explanatory Memorandum sheds no light on the underlying reasons, but the official explanation for the Article 9 version of the rule is that it ‘enables banks to extend credit to their depositors without the need to examine either the public record or their own records to determine whether another party might have a security interest in the deposit account’.²⁴ The rationale for s 57 in its other applications is to preserve the negotiable, or quasi-negotiable, status of intermediated securities, investment instruments and the like. By giving special priority status to security interests in these kinds of collateral, the statute treats them as being in some respects equivalent to negotiable instruments.²⁵ The objective is to facilitate dealings in the collateral by giving purchasers, including secured parties, an at least partial assurance of obtaining first priority which avoids the need for PPS register searches in advance of the transaction.

7.22 PPSA subs 57(2) provides that priority between two or more security interests perfected by control is to be determined by the order in which the security interests were perfected by control.

Example 13. SP1 takes a security interest in Grantor’s shares and acquires control on Date 1 by taking possession of the share certificates. On Date 2, SP2 takes a competing security interest in the same collateral and acquires control by entering into a control agreement.

Applying subs 57(2), SP1 has priority because it was the first to acquire control of the collateral.

FUTURE ADVANCES

Introduction

7.23 Consider the following example.

Example 14. On Date 1, SP1 opens a line of credit in Grantor’s favour secured by a security interest in Grantor’s inventory. On the same date, SP1 registers a financing statement and Grantor draws down \$60. On Date 2, SP2 and Grantor enter into a security agreement, giving SP2 a security interest in the same inventory. SP2 registers a financing statement and makes Grantor a loan of \$30. On Date 3, Grantor draws an additional \$50 on its line of credit with SP1. On Date 4, Grantor defaults against SP1 and SP2 and, on that date, the value of Grantor’s inventory is \$100. SP1 claims the inventory for its Date 1 and Date 3 advances. SP2 argues that its claim to the inventory in relation to SP2’s Date 2 advance has priority over SP1’s claim to the inventory in relation to SP1’s Date 3 advance.

The law

7.24 Pre-PPSA, if the grantor was a company, Corporations Act 2001 (Cth) s 282 applied in cases like Example 14. Section 282 gave SP1 priority over SP2 for its Date 3 advance if there was provision in SP1’s agreement with Grantor for further advances and one or more of the following conditions was satisfied: (1) SP1 had no actual knowledge on Date 3 of SP2’s security interest (charge); (2) SP1 and Grantor had agreed on a specified maximum amount for further advances which was noted on the register; or (3) SP1’s agreement with Grantor obliged it to make the Date 3 advance. If the grantor was not a company, the equitable doctrine of tacking applied, except in

24. Uniform Commercial Code – Secured Transactions, Official Comment on s 9-327.

25. See para 5.15 of this text, on security interests in negotiable instruments.

states which had abolished the doctrine. The rule in equity was that SP1 had priority over SP2 for the Date 3 advance, but not if SP1 had notice of SP2's Date 2 loan;²⁶ the rule applied whether or not SP1 was under a commitment to make the Date 3 advance.²⁷ Three states—Queensland, Tasmania and Victoria—had replaced the equitable doctrine with a statutory rule which gave SP1 priority where: (1) an arrangement to that effect was made between SP1 and SP2; (2) SP1 had no actual notice on Date 3 of SP2's security interest; or (3) SP1's agreement with Grantor obliged it to make the Date 3 advance.²⁸ In some states, the REV legislation enacted a different rule again for cases involving a motor vehicle.²⁹

7.25 The PPSA provisions bring some order to this chaos. PPSA subs 18(4) provides that a security agreement may provide for future advances and s 10 makes it clear that a payment is a future advance whether or not SP1 was under an obligation to make it: see para 4.9. Section 58 provides that a security interest has the same priority in respect of all advances, including future advances, secured by the security agreement. Applying these provisions to Example 14, Grantor's agreement with SP1 is for a line of credit and so it will necessarily provide for the making of future advances. The facts do not indicate whether the agreement gives SP1 the right at any point to decline further credit, but this variable is irrelevant because a payment qualifies as a future advance whether or not the agreement obliges SP1 to make it. On this basis, s 58 applies and SP1 has priority over SP2 for its Date 3 advance, without regard to the state of SP1's knowledge.

Policy considerations

7.26 PPSA s 58 gives SP1 a competitive advantage over SP2 and it forces SP2 to negotiate a subordination agreement with SP1 if SP2 wants to be sure of priority for its Date 2 loan. Functionally, the provision puts SP2 in more or less the same position as if secured creditor claims were ranked on a last-in-time, rather than a first-in-time, basis. The policy justification for giving SP1 priority, despite these consequences, is that it saves transactions costs by allowing SP1 to make subsequent advances 'without each time having, as a condition of protection, to check for filings later than his'.³⁰ From Grantor's point of view, while it is true that the statute increases the cost of subsequent borrowings from junior creditors, 'it also reduces the expenses of transactions involving the repeated extension of credit from a single senior lender'.³¹ Particularly in the case of revolving credit arrangements, as in Example 14, it is probably safe to assume that the benefits to the grantor exceed the costs.

7.27 There is another consideration, illustrated by Example 15.

Example 15. On Date 1, SP1 agrees to lend Grantor \$110, with \$60 to be paid immediately and \$50 on Date 3. Grantor gives SP1 a security interest in its inventory to secure repayment and SP1 registers a financing statement. On Date 2, SP2 and Grantor enter into a security agreement,

26. *Hopkinson v Rolt* (1861) 9 HLC 514; 11 ER 829.

27. *West v Williams* [1899] 1 Ch 132 (CA).

28. Property Law Act 1974 (Qld) s 82; Conveyancing and Law of Property Act 1884 (Tas) s 38; Property Law Act 1958 (Vic) s 94.

29. For example, Chattel Securities Act 1987 (Vic) s 10 and Chattel Securities Act 1987 (WA) s 10, both foreshadowing the PPSA rule.

30. Thomas H Jackson and Anthony T Kronman, 'Secured Financing and Priorities Among Creditors' (1979) 88 *Yale Law Journal* 1143 at p 1180 quoting from the official comment to former Article 9 s 9-312.

31. See above note 30.

giving SP2 a security interest in the same inventory. SP2 registers a financing statement and makes Grantor a loan of \$30. On Date 3, SP 1 makes the agreed \$50 payment. On Date 4, Grantor defaults against SP1 and SP2 and, on that date, the value of Grantor's inventory is \$100. SP1 claims the inventory for its Date 1 and Date 3 advances. SP2 argues that its claim to the inventory in relation to SP2's Date 2 advance has priority over SP1's claim to the inventory in relation to SP1's Date 3 advance.

In this case, the contract between SP1 and Grantor is in substance a single contract for the loan of \$110 payable in two instalments. If SP1 had paid Grantor the full \$110 at the outset, SP1 would clearly have had priority over SP2 for the whole amount. In principle, it should make no difference that SP1 paid Grantor in instalments.³²

7.28 This analysis holds only if SP1 is under a commitment to make the Date 3 payment. If SP1 has a discretion, then the transaction between SP1 and Grantor is the same in substance as if SP1 had made two separate loans to Grantor. Assume that this is in fact what happens: on Date 1, SP1 agrees to lend Grantor \$60. Grantor gives SP1 a security interest in its inventory to secure repayment and SP1 registers a financing statement. On Date 3, SP1 agrees to lend Grantor a further \$50 and takes a security interest in Grantor's inventory. On these facts, SP1's Date 3 payment is not a future advance under the Date 1 security agreement; it is a present advance made under the entirely separate Date 3 security agreement. Therefore, PPSA s 58 does not apply. By virtue of PPSA subs 21(4), however, SP1's Date 1 registration perfects both its Date 1 and Date 3 security interests: see Example 3, above. Since priority between SP1 and SP2 turns on the order of registration, SP1 still has priority over SP2 for the Date 3 advance: PPSA, subs 55(4) and (5). In principle, the outcome should be the same in the analogous case where SP1 and Grantor's Date 1 security agreement contemplates future advances but without any commitment on SP1's part. To treat the two cases differently would be to elevate form over substance.

SUBORDINATION AGREEMENTS

7.29 PPSA subs 61(1) provides that a secured party (SP1) may, in a security agreement or otherwise, subordinate its security interest to any other interest in the collateral (SP2). As indicated in Part 1, above, this provision makes it clear that the PPSA priority rules are default rules, in the sense that the parties are free to contract for a different priority ordering. The subordination agreement is the mechanism for achieving this result. PPSA subs 61(1) contemplates that the subordination agreement may be part of the security agreement between SP1 and Grantor or, alternatively, it may take the form of a separate agreement between SP1 and SP2. In the first case, SP1 agrees with Grantor to subordinate its security interest to SP2. SP2 is not a party to the contract, but para 61(2)(b) avoids privity of contract issues by providing that the subordination provision may be enforced by a third party for whose benefit the provision was intended.

7.30 PPSA s 61 relates to the subordination of security interests, not debt subordination. Debt subordination is discussed in paras 3.38–3.40, above. Debt subordination is different from security interest subordination; in a debt subordination, the subordinating creditor agrees that payment of its claim should be postponed until payment of the benefiting creditor's claim, whereas in a security interest subordination, the subordinating creditor (SP1) agrees that its security interest should be ranked behind the benefiting creditor's (SP2's) security interest. In other words, a security interest subordination subordinates the ranking of SP1's security interest, not the payment of its debt.

32. Alan Schwartz, 'A Theory of Loan Priorities' (1989) 18 *Journal of Legal Studies* 209 at p 252.

The implication is that if the collateral is insufficient to satisfy SP2's claim, SP1 and SP2 may both enforce their claims against the grantor and, if the grantor becomes bankrupt, they may both prove their claims and will share *pro rata* in the bankruptcy distribution.³³

7.31 There are three possible forms a security interest subordination might take.³⁴ The first possibility is that the agreement may create only a personal obligation on SP1's part not to claim the collateral ahead of SP2. If SP1 breaches the obligation, SP2 may sue for damages but SP2 has no proprietary remedy against SP1. The second possibility is that subordination amounts to a partial waiver. SP1 agrees that, if there are no other parties involved, it will not enforce its security interest ahead of SP2. On the other hand, if a third party claims the collateral, SP1 may enforce its security interest, but it must account to SP2 for the enforcement proceeds, up to the value of SP2's claim. Again, if SP1 breaches its obligations, SP2 may sue for damages, but it does not have a proprietary remedy against SP1. The third possibility is that the agreement constitutes either an outright or security transfer to SP2 of SP1's secured claim, in which case SP2 acquires a proprietary interest in the claim; either way, the PPSA applies and SP2 must register a financing statement but, subject to this, SP2's claim is enforceable in SP1's bankruptcy or other insolvency proceedings: see paras 3.38–3.40.

7.32 PPSA para 61(2)(a) provides that a subordination agreement is effective according to its terms. Consequently, it is for the parties to decide which of the above outcomes they want and the court must construe the subordination agreement to determine the parties' intentions. PPSA subs 12(6) creates a presumption that a subordination agreement does not create a security interest and the result is that the parties must use clear language if they intend otherwise. Unless it creates a security interest, a subordination agreement does not have to be registered. However, the statute gives SP1 the option of indicating on its financing statement whether the security interest is, or is to be, subordinated to another security interest: see para 6.48 of this text.³⁵

CIRCULAR PRIORITIES

7.33 Example 16. Grantor gives competing security interests to three secured creditors, SP1, SP2 and SP3, with priority in that order. SP1 and SP3 enter into an agreement under which SP1 agrees to subordinate its security interest to SP3. Grantor defaults owing SP1 \$200,000, SP2 \$100,000 and SP3 \$150,000. The value of the collateral is \$225,000.

In the absence of the subordination agreement, SP1 would be entitled to \$200,000 out of the collateral sale proceeds; SP2 would receive \$25,000; and SP3 would get nothing. The subordination agreement changes the distribution, but the nature of the change depends on the terms of the agreement. There are two main possibilities. The first is that the parties intended SP1 to receive nothing until SP3 has been paid in full. This is known as a contractual subordination, or a full subordination: see *Re CIF Furniture Limited* 2011 ONCA 34. The effect of a full subordination is to place SP1 at the back of the queue, behind SP2 and SP3 in that order. The resulting distribution is as follows: \$100,000 to SP2; \$125,000 to SP3; and nothing to SP1. This gives SP2 a windfall: it was not a party to the subordination agreement, but it ends up being the main beneficiary. In *Re CIF Furniture Limited*, the Ontario Court of Appeal held that clear wording would be needed

33. Roderick J Wood, 'Subordination Agreements, Bankruptcy and the PPSA' (2010) 49 *Canadian Business Law Journal* 65 at p 69.

34. See above note 33, at pp 89–90.

35. PPSA subs 153(1), Table, Item 6.

to justify the conclusion that the parties intended a full subordination or, in other words, that SP1 intended to subordinate its security interest not just to SP3 but to SP2 as well. The court concluded that, in the case before it, the documents did not support this construction. The court also looked at the commercial background to the transaction and the parties' likely motivations. The facts, briefly stated, were as follows. SP1, apart from being a major creditor, also held a substantial shareholding in the grantor company. The money SP2 loaned the grantor had all been spent and SP3 was providing the grantor with new finance to help it keep afloat. From SP1's point of view, it made sense to subordinate its security interest to SP3 because, with luck, SP3's funds would help the grantor's financial recovery and protect at least some of SP1's investment and so SP1 had a direct interest in encouraging SP3 to make the loan. On the other hand, SP2's loan deal with the grantor was a matter of history: SP2 had already made the loan, the money was gone and there was no commercial advantage to SP1 in giving SP2 priority. In summary, the wording of the subordination agreement, coupled with the background commercial circumstances, pointed strongly to the conclusion that SP1 did not intend a full subordination.

7.34 The other possibility, and the one the court in the *CIF* case in the end accepted, is that SP1 intended only a partial subordination. In a partial subordination, SP1 gives SP3 first claim on the collateral to the value of SP3's claim and SP1 is entitled to any surplus up to the value of SP1's claim. Any remaining surplus is applied in satisfaction of SP2's claim. On this basis, the distribution in Example 16 would be as follows: \$150,000 to SP3; \$50,000 to SP1; and \$25,000 to SP2.³⁶ One noteworthy feature of this outcome is that SP1's and SP3's subordination agreement does not affect SP2's entitlement: SP2 recovers the same amount as it would have without the agreement. In other words, in a partial subordination, SP1 and SP3 in effect contract round SP2.

7.35 PPSA s 59 provides as follows:

A security interest (the first security interest) has priority over another security interest (the last security interest) if, by the operation of this Act (including this section):

- (a) the first security interest has priority over security interests of a particular kind (the intermediate security interests); and
- (b) the intermediate security interests have priority over the last security interest.

This provision, which is unique to the Australian PPSA, seems to have been drafted with a case like Example 16 in mind. Leaving aside the subordination agreement, SP1 holds the first security interest (in the sense that it has first priority), SP2 holds the intermediate security interest (in the sense that it has second priority) and SP3 holds the last security interest (in the sense that it has third priority). On one reading, s 59 means that SP1 retains priority over SP3 notwithstanding the subordination agreement. In other words, the provision appears to preclude subordination agreements in a case involving one or more intermediate security interests. As a matter of policy, this would be an undesirable outcome because, as the *CIF Furniture* case demonstrates, there may be good commercial reasons for subordinations even if there is an intermediate party involved.

7.36 Section 59 is apparently aimed at avoiding potentially unresolvable circular priority problems (where SP3 has priority over SP1, SP1 has priority over SP2 and SP2 has priority over

36. See *Royal Bank of Canada v General Motors Acceptance Corporation of Canada Ltd* (2006) 274 DLR (4th) 372 (NFCA); *Re CIF Furniture Limited* 2011 ONCA 34.

SP3). As the above discussion indicates, however, subordination agreements do not raise this concern. In the case of a partial subordination, the apparent circular priorities issue disappears once it is recognised that SP1's security interest is subordinated only to the value of SP3's claim while, in the case of a full subordination, there is not even the hint of a circular priorities problem because SP1 is subordinated to both SP2 and SP3. In summary, at least in its application to cases like Example 16, s 59 is both unnecessary and commercially disruptive. The solution is to treat the priority rule in s 59 as a default rule, like all the other PPSA priority rules. This leaves the parties free to contract around s 59 by indicating their preference for a different priority order. On this basis, if the parties enter into a full subordination agreement, the priority order should be SP2, SP3 and SP1, while if their agreement is for a partial subordination, the priority order should be SP3 (to the value of its claim), SP1 and SP2.

THE DOUBLE GRANTOR RULES

7.37 The main PPSA priority rules are drafted on the assumption that the competing security interests were given by a common grantor. However, there may be cases where more than one grantor is involved.

Example 17. On Date 2, Grantor 1 gives SP1 a security interest in its printing press and SP1 registers a financing statement. Previously, on Date 1, Grantor 2 had given SP2 a security interest in all Grantor 2's present and after-acquired personal property and SP2 registered a financing statement on the same day. On Date 3, Grantor 1 sells the printing press to Grantor 2. The sale is outside the ordinary course of Grantor 1's business.³⁷ On Date 4, SP1 learns about Grantor 1's sale of the printing press. It immediately registers a new financing statement incorporating Grantor 2's details and claims the printing press from Grantor 2. SP2 disputes SP1's claim.

SP1's security interest ceases to be perfected by registration on Date 2 when Grantor 1 sells the printing press. However, it is temporarily perfected from Date 2 until Date 4 when it is again perfected by registration: PPSA s 34.³⁸ If the default priority rules in PPSA s 55 applied, SP2 would have priority over SP1. SP1 is continuously perfected from Date 2 and so this is its priority time for the purposes of subs 55(4). However, SP2's priority time is Date 1: see paras 7.5–7.6 above. PPSA s 67 enacts a special priority rule which displaces this outcome. It provides that SP1 has priority provided that its security interest was perfected immediately before the transfer and was continuously perfected thereafter.³⁹ There is a corresponding provision in Article 9 and, with the exception of Ontario, all the other PPSAs.⁴⁰ The policy explanation is that SP2 is better placed than SP1 to avoid the priority dispute: SP2 could have investigated the source of the printing press and discovered SP1's security interest before making an advance against the press whereas, given

37. Therefore, Grantor 2 takes the printing press subject to SP1's perfected security interest; neither PPSA s 32 nor s 46 apply to give Grantor 2 clear title: Contrast Example 22, below.

38. See paras 6.66–6.71 of this text.

39. Sections 67 and 68 do not apply if either security interest is perfected by control: para 66(1)(d). Note 1 to subs 66(1) makes it clear that if either or both security interests are perfected by control, the priority rules in s 57 apply.

40. United States Uniform Commercial Code – Secured Transactions s 9-325; Saskatchewan PPSA subs 35(8); New Zealand PPSA s 88.

the chronology, any inquiries SP1 might make before acquiring its security interest would not reveal SP2's competing claim.⁴¹

7.38 Example 18. On Date 1, SP1 takes a security interest in Grantor 1's printing press and registers a financing statement. On Date 2, Grantor 1 sells the printing press to Grantor 2. The sale is not in the ordinary course of Grantor 1's business. On Date 3, Grantor 2 gives SP2 a security interest in the printing press and SP2 registers a financing statement. On Date 4, SP1 learns about Grantor 1's sale of the printing press. It immediately registers a new financing statement incorporating Grantor 2's details and claims the printing press from Grantor 2. SP2 disputes SP1's claim.

PPSA para 66(1)(c) provides that s 67 applies whether SP2 acquires its security interest before or after the sale of the collateral to Grantor 2.⁴² In Example 18, SP2 acquired its security interest after the sale, but s 67 still applies and so SP1 has priority. On the facts of Example 18, the s 55 default rules would have produced the same result: since SP1 is continuously perfected from Date 1, its priority time is Date 1 and so it has priority over SP2.

7.39 Example 19. On Date 1, SP1 takes a security interest in Grantor 1's printing press and registers a financing statement. On Date 2, Grantor 1 sells the printing press to Grantor 2. The sale is not in the ordinary course of Grantor 1's business. On Date 3, Grantor 2 gives SP2 a security interest in the printing press and SP2 registers a financing statement. On Date 4, SP1 learns about Grantor 1's sale of the printing press but it does not reperfect its security interest until Date 5, more than five business days after Date 4.

SP1's security interest is unperfected from five business days after Date 4 until Date 5: s 34.⁴³ Therefore, s 67 does not apply because SP1's security interest was not continuously perfected following the sale on Date 2. The result would be the same if the s 55 default priority rules applied: since SP1's security interest was unperfected from five business days after Date 4 until Date 5, its priority time is Date 5, not Date 1, and so SP2 has priority. However, s 68 is relevant in this connection. Section 68 applies if: (1) the collateral is not serial-numbered collateral; (2) SP1's security interest was perfected by registration immediately before the sale on Date 2; and (3) SP1's security interest becomes unperfected and is later reperfected and is continuously perfected thereafter. Subsection 68(1) provides that, in these circumstances, SP1 may obtain priority by serving a notice on SP2. The notice must be in the approved form and it must state that SP1 expects to perfect a security interest in the transferred collateral, describe the transferred collateral and set out the effect of subs 68(1) and (2).

7.40 Subsection 68(2) enacts an exception in SP2's favour catering for the case where SP2 makes an advance to Grantor 2 before SP1 reperfects its security interest or serves a subs 68(1) notice. Subsection 68(2) applies if: (1) SP2's security interest is perfected immediately before SP1's

41. United States Uniform Commercial Code – Secured Transactions, Official Comment on s 9-325. SP1's security interest may secure further advances. In that case, SP1 may want to conduct a register search before each advance to check for intervening security interests. But SP1 has no reason to search against someone other than Grantor 1: United States Uniform Commercial Code – Secured Transactions, Official Comment on s 9-325.

42. Compare with Saskatchewan PPSA subs 35(8) which only applies if SP2 acquires its security interest *before* the sale. In other cases, the default priority rule applies. Article 9, s 9-135 is not limited in this way. Nor is New Zealand PPSA s 88.

43. See paras 6.66–6.71 of this text.

security interest becomes reperfected; and (2) Grantor 2 acquired the collateral without actual or constructive knowledge that the sale constituted a breach of Grantor 1's security agreement with SP1.⁴⁴

Example 20. On Date 1, SP1 takes a security interest in Grantor 1's printing press and registers a financing statement. On Date 2, Grantor 1 sells the printing press to Grantor 2. The sale is not in the ordinary course of Grantor 1's business and Grantor 2 has no knowledge of SP1's security interest. On Date 3, Grantor 2 gives SP2 a security interest in the printing press and SP2 registers a financing statement. On Date 4, SP1 learns about Grantor 1's sale of the printing press. On Date 6, it serves a subs 68(1) notice on SP2 and on Date 7 it reperfects its security interest. Date 7 is more than five business days after Date 4. In the meantime, on Date 5, SP2 makes an advance of \$100 to Grantor 2.

Applying subs 68(2), SP2 has priority over SP1 for the Date 5 advance. On the other hand, SP1 continues to have priority under subs 68(1) with respect to any advances SP2 makes after Date 6.

7.41 Sections 67 and 68 do not apply unless SP1's security interest was perfected immediately before the transfer and, in the case of s 68, perfection must be by registration.

Example 21. On Date 2, Grantor 1 gives SP1 a security interest in its printing press but SP1 does not register a financing statement or take any other steps to perfect its security interest. Previously, on Date 1, Grantor 2 had given SP2 a security interest in all Grantor 2's present and after-acquired personal property and SP2 registered a financing statement on the same day. On Date 3, Grantor 1 sells the printing press to Grantor 2. The sale is outside the ordinary course of Grantor 1's business. On Date 4, SP1 learns about Grantor 1's sale of the printing press. It immediately registers a financing statement and claims the printing press from Grantor 2. SP2 disputes SP1's claim.

SP1's security interest was unperfected before the sale on Date 3 and so ss 67 and 68 do not apply. The s 55 default priority rules apply instead: SP1's priority time is Date 4, SP2's priority time is Date 1 and so SP2 has priority.⁴⁵ The award of priority to SP2 is premised on the belief that SP1's failure to perfect its security interest could have misled SP2.⁴⁶

7.42 Sections 67 and 68 also only apply on the assumption that SP1's security interest is not extinguished by Grantor 1's sale of the collateral to Grantor 2.

Example 22. Grantor 1 is a jeweler. On Date 1, SP1 takes a security interest in Grantor 1's inventory. The security agreement limits Grantor 1's freedom to sell the inventory and, in violation of these limits, on Date 2 Grantor 1 sells a necklace to Grantor 2. The sale is in the ordinary course of Grantor 1's business and Grantor 2 has no knowledge of the irregularity. On Date 3, Grantor 2 gives SP2 a security interest in the necklace and SP2 registers a financing statement.

In this case, PPSA s 46 applies. The result is that Grantor 1 takes the necklace free of SP1's security interest: see Chapter 10. In other words, SP1 loses its security interest and so it has no claim on the necklace against Grantor 2 or any third party, including SP2, who has acquired an interest in the necklace from Grantor 2.⁴⁷

44. On the meaning of actual and constructive knowledge, see paras 10.19–10.20.

45. See Note 2 to PPSA subs 66(1) which makes it clear that if ss 67 and 68 do not apply, s 55 applies instead.

46. United States Uniform Commercial Code – Secured Transactions, Official Comment on s 9-325.

47. See New Zealand PPSA subs 88(2), which makes this point explicitly. See also, for example, Saskatchewan PPSA subs 35(9).