

focus

on

Insolvency Law

December 2008

The logo for Fraser Milner Casgrain LLP, consisting of the letters 'FMC' in white on a dark blue square background.

FRASER MILNER CASGRAIN LLP

SECURITY INTEREST PREVAILS OVER MONEY PAID INTO COURT

Stone Sapphire Ltd. (“Stone”) was a supplier of international goods to Transglobal Communications Ltd. (“Transglobal”), a local distributor to retailers. Stone was owed in excess of \$2,000,000 for unpaid invoices from Transglobal and brought an action to recover this amount. Stone obtained judgment. Over \$1,500,000 was paid into court so that the judgment enforcement would be temporarily stayed.

HSBC was Transglobal’s banker. HSBC had obtained and perfected a security interest in all the present and after acquired personal property of Transglobal, and also held Bank Act security. HSBC disputed Stone’s entitlement to the funds paid into court, and argued Stone was at best a judgment creditor (and not a secured creditor) and therefore subordinate to HSBC’s security.

Stone argued the monies paid into court were free from the security interest of the bank on several grounds. First, it argued the monies were paid “in the ordinary course of business”. This falls generally under an exception in the Personal Property Security Act (“PPSA”) which allows for goods to be dealt with in the ordinary course free from security interests. This exception allows trade and commerce to flow without requiring purchasers to review the Personal Property Registry before every purchase. Stone’s argument centred on the theory that if the monies had been paid when invoiced they would have not been subject to HSBC’s security – the fact that the monies

were eventually paid involuntarily, it was argued, should not make any difference.

Stone’s second major argument was based in common law licence theory. This theory was recently described by the Supreme Court as follows: ¹

[L]icence theory holds that a bank’s security interest in a debtor’s inventory, though it be fixed and specific, is subject nevertheless to a licence in the debtor to deal with that inventory in the ordinary course of business. Consequently, says the theory, the bank’s claim to the inventory must give way to any debts incurred in the ordinary course of business.

The Court first determined that Stone had no property interest in the funds paid into court. HSBC’s security therefore was prima facie determinative of the parties rights, as the money at the time it was paid in could only have been part of the present or after-acquired personal property of Transglobal. Unless Stone could prove exceptional entitlement to the funds, it would rank subordinate as an unsecured judgment creditor.

Considering the “ordinary course of business” argument, the Court reviewed the jurisprudence and favoured the general test that the transaction “must fall into place as part of the undistinguished common flow of business carried on, calling for no remark and arising out of no special or peculiar situation”. As the payment of monies into court by Transglobal was an excessive amount, was made in peculiar circumstances, and was an isolated

¹ Royal Bank v. Sparrow Electric Corp., [1997] 1 S.C.R. 411 at para. 91.

event, the Court found it was not sufficiently within the ordinary course of business such that it could prevail over HSBC's security.

HSBC argued, in regard to the common law license theory, that this exception has been subsumed by the PPSA, which effectively grants rights to sell collateral free of security interests without an implied license being necessary. The Court declined to decide if this was correct, instead applying the common law license theory to the facts.

The Supreme Court has stated that the license theory operates by creating a "defeasible interest; but the event of defeasance is the actual sale of the inventory and the actual application of the proceeds against an obligation to a third party".² Three factors were gleaned from the reasons of the Supreme Court:

1. The source of the payment must be proceeds from a sale of inventory.
2. The recipient of the payment must be a third party.
3. The object of the payment must be in "satisfaction of obligations that are immediately incidental to an actual sale of the inventory".

The reasons for rejection by the Court of the license theory were that the source of the monies paid in was largely unknown, and would only partly be proceeds from the sale of inventory, and that the payment in was not made to Stone as a third party. The Court concluded in light of Stone's lack of defensible position, that the monies paid in to stay the enforcement of its judgment were subject to the security of HSBC, despite having been "earmarked" for Stone when paid into Court.

For further information please contact David Mann at 403 268-7097 or David LeGeyt at 403 268-3075, or visit our **website www.fmc-law.com/insolvency**.

² Sparrow, supra at para. 94.