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• PURCHASE-MONEY SECURITY INTERESTS: CROSS-COLLATERALIZING WITHOUT WAIVERS •

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The recent decision of the Alberta Court of Queen's Bench, *Royal Bank of Canada v. Ramco Sales Inc.*, [2010] A.J. No. 56, highlights the danger of using a purchase-money security interest ("PMSI") when trying to cross-collateralize assets under different financings with the same obligor. Generally, a PMSI secures a specific piece of collateral under one agreement. Often, finance companies will use collateral that is subject to one security agreement as collateral to secure obligations under other agreements. The *Ramco* decision makes it clear that if a PMSI is utilized by a secured creditor and there is a prior secured creditor, the cross-collateralization process will fail. The PMSI creditor will have a claim over the specific asset, but will not be able to use the surplus from the sale of the asset to secure shortfalls, if any, on other advances.

In order to avoid the above noted result, the PMSI creditor must obtain a waiver of interest or intercreditor agreement from all prior secured creditors. While not discussed in the case, the result may be different if the financing were accomplished through a true lease structure as opposed to a loan or finance lease.

BACKGROUND

Pursuant to a loan agreement and security, Ramco Sales Inc. ("Ramco"), an Alberta-based equipment supplier, purchased certain equipment with funds advanced by Canadian Western Bank ("CWB"). Of significance were four pieces of equipment located on its property, a Mack truck, a skid office, a double drop trailer and a Cadillac Escalade. There was money owing with respect to other equipment covered by the

agreement. The other equipment was not located on the property.

PricewaterhouseCoopers (the "Receiver") was appointed receiver and manager of Ramco. The Royal Bank of Canada ("RBC") had a prior registration against Ramco for all present and after-acquired personal property. CWB claimed a PMSI with respect to each piece of equipment. CWB sought possession of the equipment.

CROSS-COLLATERALIZATION AND PMSI

CWB took the position that any equity from one piece of equipment must first be applied against the deficiency, if any, of any of the other three pieces of equipment. If the indebtedness owed to CWB for the pieces of equipment was then paid in full, any remaining equity would next go towards paying off the balance owing on the entire CWB loan. Once CWB was paid in full, the Receiver would then receive funds, if there were any funds still available.

The Receiver and RBC took the position that each piece of equipment was discrete. The surplus funds, if any, of the sale of a piece of equipment should go to the Receiver and should not be applied to any deficiency with respect to the other equipment or the CWB agreement.

The court identified two general characteristics of PMSIs. First, the loan advanced to the debtor must be for the debtor's acquisition of a specific new asset. Second, the PMSI priority is limited to a loan that can be traced to identifiable, discrete items of property. A creditor must be able to demonstrate that the loan

was used by the debtor to purchase a specific and identifiable asset.

The court appreciated that CWB could demonstrate its loan had been used by Ramco to purchase the pieces of equipment, even those that had not been located. Each piece of equipment was collateral for the CWB loan. The court held that insofar as the PMSI was concerned, the *Personal Property Security Act* (Alberta) [the *PPSA*], RSA 2000, c. P-7, mandates that any surplus after the sale of the collateral would be paid first to the party with a subordinate security interest in the collateral, in this case RBC. The overall intent of the *PPSA* is to provide an ordered regime for financing in a manner that is balanced for a debtor and its creditors. To permit a PMSI creditor to use surplus funds from an identifiable, existing asset to pay off debt with respect to other identifiable, existing assets would allow the PMSI creditor to usurp the priority of the prior secured creditor.

In the result, CWB's PMSI priority was limited. Any equity left after each piece of equipment was sold would be paid to the Receiver.

WHO SELLS THE EQUIPMENT?

In another issue that arose, CWB wanted to sell the equipment since it already obtained offers on three of the four pieces of equipment. CWB argued that it was in a better position to obtain the best price for the equipment. The court agreed that it made sense for CWB to sell the equipment, other than the skid office. The skid office had become attached to another Ramco building. If removed, the skid office would create a hole in the wall that would diminish the value of the property and would require remediation before the Receiver could sell the property. The Receiver was

given the opportunity to market the property including the skid office. CWB was to be provided its fair share of the proceeds of the sale.

This decision indicates that the courts may be flexible when it comes to the sale of the debtor's assets. The party in a position to obtain the best price for the asset will likely be permitted to proceed with the sale.

OBTAIN WAIVERS

In sum, when dealing with collateral that is cross-collateralized and subject to a PMSI, secured creditors should obtain a waiver from existing prior secured lenders. Entering into a subordination or an inter-creditor agreement, depending on the nature of the transaction, will allow creditors to deal with their competing interests in a debtor.

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