

Ontario Court of Appeal grants priority to senior secured lender in equipment lease dispute

March 05, 2024

On Feb. 16, 2024, the Ontario Court of Appeal (ONCA) released its decision in *Royal Bank of Canada v. Cutler Forest Products Inc.*,¹ in a defining moment for Ontario's legal landscape. The ONCA affirmed Justice Penny's decision at the Ontario Superior Court of Justice (Commercial List) (the Superior Court) that due to Paccar Leasing Company Ltd.'s (Paccar) failure to obtain a valid purchase money security interest (PMSI) under the Ontario Personal Property Security Act (PPSA), its claim was subordinate to the Royal Bank of Canada (RBC), which held a first-in-time registered security interest over all the debtor's assets, property and undertaking.

The decision marks a critical juncture in PPSA jurisprudence, addressing a long-standing scarcity of case law in Ontario since the Act's 2007 expansion to include leases "for a term of more than (1) year." It acts as a stark reminder for lessors and secured parties alike that when dealing with leases exceeding 12 months, the failure to secure a PMSI can lead to a subordinate position to prior registrations. Moreover, this appears to be the first reported decision in which an Ontario court has interpreted Section 57.1 of the PPSA, which provides that Part V of the PPSA does not apply to true leases.

Background

As the senior secured lender of Cutler Forest Products Inc. (Cutler), RBC acquired a first-ranking general security interest in all of Cutler's personal property in 2007, including equipment. Paccar leased three trucks (the Paccar Trucks) to Cutler, pursuant to a lease with a term of more than one year (the Paccar Lease). This became a focal point of dispute. The Superior Court determined that the Paccar Lease was a "true lease," meaning the purpose of the lease was not to secure payment or performance of an obligation by Cutler. Pursuant to a true lease, the lessee pays for the use of the loaned goods for a period of time until it is required to return the goods to the lessor, who retains title to the goods. However, Paccar failed to take steps to perfect a valid PMSI in the Paccar Trucks.

The Fuller Landau Group Inc., acting as the Court-appointed Receiver for Cutler (the Receiver), brought a motion for advice and directions from the Superior Court on the priority dispute between RBC and Paccar concerning the Paccar Trucks.

Position of the parties

True Leases and the 2007 PPSA Amendments

One of Paccar's arguments was that the true lease nature of the Paccar Trucks excluded them from Cutler's estate and, therefore, from the Receiver's power to sell or dispose of them. Paccar contended that as the titleholder under a true lease, its interest should take precedence over those of RBC or the Receiver, both of whom derive their interests from Cutler. Paccar argued that neither RBC nor the Receiver should have rights exceeding those of the lessee.

Historically, the distinction between true leases and leases that secure payment or performance of an obligation was a significant one, as the PPSA only applied to the latter, which were considered security agreements disguised as leases. This changed in 2007 when the PPSA was amended to include true leases within a term of more than one year in the definition of "security interest," bringing them within the scope of the Act.

Counsel for the Receiver and RBC argued²:

"The 2007 amendments to Ontario's PPSA unambiguously brought 'true' leases within the PPSA registration system. Paccar's interest as lessee became registerable. Its priority could have been, but was not, preserved by the registration of a PMSI in the prescribed manner and within the prescribed time... Paccar's interest in the trucks became subordinated to the RBC's prior in time, perfected security interest in the Debtor's property (which included the trucks - the Debtor's right to exclusive possession under the lease being a form of property)."

Section 57.1 and the exemption of true leases from Part V

Paccar also argued that the Receiver's proposed sale of the Paccar Trucks was a form of enforcement of RBC's security within the meaning of Part V of the PPSA, which sets out a secured party's rights and remedies upon default. Pursuant to Section 57.1, which provides that Part V only applies to security interests that secure payment or performance of an obligation, true leases are exempt from the rights and remedies under Part V and the Receiver therefore did not have a right to enforce on the Paccar Trucks.

On the other hand, The Receiver and RBC argued that neither the Receiver nor RBC was seeking to rely on the rights or remedies under the PPSA. Rather than exercising the "self-help" remedies set out in Part V, including possession, power of sale and foreclosure, RBC had applied for the appointment of the Receiver pursuant to Section 243 of the Bankruptcy and Insolvency Act and Section 101 of the Courts of Justice Act. Part V and the exemption of true leases under Section 57.1 were therefore irrelevant.

The decision

Both the Superior Court and ONCA accepted the arguments presented by the Receiver and RBC.³

The Superior Court held that, irrespective of whether the Paccar Lease was a true lease, it was governed by the priority and enforcement rules under the PPSA. The ONCA, in affirming this decision, highlighted that the post-2007 legal framework shifted the focus **from common law notions of title or ownership (i.e, the “true lease” question) to the priority of registration.** The amendments signify a modern approach in which the PPSA applies to all transactions that create a security interest in personal property, regardless of their form or the intention of the parties.

In addressing Paccar’s argument under Section 57.1 of the PPSA, this marked the first time an Ontario court interpreted this provision, which specifies that Part V applies only to security interests securing payment or performance of an obligation. The ONCA interpreted this to mean that the self-help remedies set out in Part V (including possession, power of sale and foreclosure) do not apply to collateral under a true lease. However, the realization of property in a court-appointed receivership does not constitute a self-help remedy under Part V. Instead of seeking to take possession, dispose of, or foreclose on the trucks without court intervention, RBC had chosen to initiate a court-supervised process by applying for the appointment of a receiver, independent from Part V of the PPSA. In light of the 2007 amendments, all leases of more than one year are subject to the priority scheme and the registration requirements under the PPSA. Part V of the PPSA does not subvert these rules.

Accordingly, the ONCA dismissed Paccar’s appeal from the decision of the Superior Court that authorized the Receiver to sell the Paccar Trucks, which Paccar was ordered to relinquish to the Receiver and provided that RBC had priority over Paccar.

Key takeaways

- **Adherence to PPSA Priority Rules:** Adherence to the PPSA priority regime is not just advisable, but imperative for safeguarding interests in leased or financed goods. In the face of insolvency or default, the transaction’s structure becomes crucial in preserving priority status, elevating the importance of strategic planning and legal diligence in financial dealings. Secured parties should periodically review their security agreements and registrations to ensure their interests remain perfected and have priority, especially when dealing with debtors who have multiple creditors.
- **Importance of PMSIs for Leased Goods:** Equipment lessors must be aware that their interests may be subordinate to those of existing secured creditors, such as an operating lender, if they do not take steps to protect their interests. Equipment lessors should prioritize obtaining a PMSI for leases exceeding 12 months under the PPSA.
- **PPSA Section 57.1:** The decision provides much-needed guidance regarding the implications of Section 57.1. The decision confirms the notion that an application by a secured creditor for a court-appointed receiver is independent of and not in conflict with the remedies under Part V of the PPSA.

This case sets an important legal benchmark in Ontario, providing much-needed judicial guidance on the application of the PPSA to leases exceeding one year. For more information, please reach out to any of the key contacts listed below.

¹ Royal Bank of Canada v. Cutler Forest Products Inc., [2024 ONCA 118](#).

² 2022 ONSC 6629 at para 11.

³ Borden Ladner Gervais LLP acted as counsel for RBC in this matter both before the Ontario Superior Court of Justice (Commercial List) and the Ontario Court of Appeal.

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