CASE COMMENT ON ALBERTA TREASURY BRANCHES v. HARDER (TRUSTEE OF): SUBJECIVITY AND ACTUAL KNOWLEDGE JOIN THE TEST ON WHAT IS SERIOUSLY MISLEADING

By: Darren R. Bieganek, Partner, Duncan & Craig LLP

INTRODUCTION

Prior to the spring of 2004, the accepted practice among bankruptcy trustees in consumer bankruptcies in this jurisdiction was to disallow a secured creditor's claim where there was an error in the serial number of a serial numbered consumer good and a search in the registry using the correct serial number failed to disclose the secured creditor's financing statement as either an exact or inexact match. This was so even where a search using the correct name of the debtor disclosed a registration in favor of that creditor. The rationale was that the error was considered seriously misleading and therefore, in the case of serial numbered consumer goods, that rendered the security interest unperfected and therefore not effective against a trustee in bankruptcy pursuant to s. 20(a)(i) of the *Personal Property Security Act,* R.S.A. 2000, P-7 as amended (the "*PPSA*").

This practice followed an objective test along the analysis of Registrar Funduk in *Primus Automotive Financial Services Canada Ltd. v. Kirkby (Trustee of)* 1998 CarswellAlta 57 ("*Primus*") which applied the Alberta Court of Appeal decision in *Case Power & Equipment v. 366551 Alberta Ltd. (Receiver of)* 1994 CarswellAlta 225 ("*Case Power*").

This practice, and the notion that the test is an objective one, has been turned on it's head by the Alberta Court of Queen's Bench decision in *Harder (Bankrupt) v. Alberta Treasury Branches, 2004 ABQB 285* ("*Harder*").

THE HARDER DECISION

The Court's decision in the case is best summed up by directly quoting the first two paragraphs of the reasons (2004 ABQB 285 paragraphs 1 and 2):

> A serial number error in the registration of a security interest pursuant to the provisions of the *Personal Property Security Act*, R.S.A. 2000, c. P-7, as amended, ("the PPSA") does not defeat the claim of the secured creditor as against a subsequent secured creditor or bankruptcy trustee *who obtains actual knowledge of the existence of the security as a result of the name search of the debtor, or otherwise.*
>
> A bankruptcy trustee was in error to disallow as secured the claim of a creditor who filed a financing statement against a holiday trailer under an incorrect serial number *where the trustee learned of the existence of the underlying debt as a*

> *result of being told of it by the bankrupts at the time of making their assignment* into bankruptcy and, subsequently, as a result of a registry search conducted under their names as well as under the correct serial number of the trailer, although the latter search revealed nothing.
>
> (*Emphasis added*)

FACTS

The facts were not at issue. The Harders purchased a holiday trailer. The Alberta Treasury Branches ("ATB") provided financing to the extent of about $15,000. The Harders provided ATB with a security interest in the holiday trailer. The Court noted that the ATB registered a financing statement. The correct debtor names were used and the make model and year were correct. However, the serial number was incorrect. The correct serial number was 2TTWW2201PDGQO872. The registration referred to by the Court was made in 2002 in relation to serial number 2TTWW2201PDGOO872. The 13th digit was wrong and is underlined.

What the Court does not make reference to is the fact that the ATB actually made more than one registration against this holiday trailer. An earlier registration was made in 1999, presumably at the time of purchase. It too was wrong. The registry search disclosed this registration as against serial number 2TTWW2201PDG1O872. Again, the 13th digit was wrong and is underlined (*Affidavit of Dan McDicken, sworn December 3, 2003, Exhibit A, PPR Search Result dated July 29, 2003, QB Actions 24-104120/104121*).

The Harders assigned themselves into bankruptcy on August 5, 2003. Consistent with their statutory duties under the *Bankruptcy and Insolvency Act,* R.S.C. 1985, c. B-3 as amended (the "*BIA*"), the Harders disclosed the existence of the trailer, the loan from the ATB and the security interest given to the ATB in the trailer.

The trustee conducted a serial number search at PPR using the correct serial number. The result did not reveal either an exact or an inexact match using that serial number. The ATB financing statements were revealed when the debtors' names were used.

Consistent with the practice, and Registrar Funduk's decision in *Primus*, upon ATB filing it's proof of claim with the trustee, the trustee disallowed the secured claim on the ground that there was a seriously misleading error in the registration and as a result, the ATB security interest was not perfected at the date of bankruptcy and was therefore ineffective against the trustee.

The ATB appealed and were successful before the Registrar who allowed the appeal without reasons. The trustee appealed to Queen's Bench.

THE DECISION

The Court acknowledged that the holiday trailer fell within the definition "serial number goods" as found in the *PPSA* and, at least implicitly, appears to have recognized that it was a consumer good and was therefore required to be registered by way of serial number in order to be perfected against the trustee.

The Court also acknowledged that the registration was not revealed as either an exact or inexact match when conducting a search using the correct serial number but that a registration was revealed when conducting a search using the debtor names.

The Court was also very live to the issue of what has been described as the trustee obtaining a "windfall' as a result of the potential error.

The issue for the Court was whether the error in the serial number rendered the registration seriously misleading. The applicable sections of the *PPSA*, as quoted by the Court, are (at paragraph 9):

> s. 20 A security interest
>
> > (a) in collateral is not effective against
> >
> > > (i) a trustee in bankruptcy if the security interest is unperfected at the date of the bankruptcy...
>
> s. 25 ...registration of a financing statement perfects a security interest in collateral.
>
> s. 43(6) The validity of the registration of a financing statement is not affected by a defect, irregularity, omission or error in the financing statement or in the registration of it unless the defect, irregularity, omission or error is seriously misleading.
>
> (7) ...where collateral is consumer goods of a kind that is prescribed by the regulations as serial number goods, and there is a seriously misleading defect, irregularity, omission or error in...
>
> > (b) the serial number of the collateral,
>
> the registration is invalid.
>
> (8) Nothing in subsections (6) and (7) shall require, as a condition to a finding that a defect, irregularity, omission or error is seriously misleading, proof that anyone was actually misled by it. (emphasis added by the Court).

The Court then analyzed jurisprudence from five Appellate Courts, including the Alberta Court of Appeal, in relation to the seriously misleading issue. She notes that none of the cases have considered a case identical to the facts before her, i.e. an incorrect serial number but correct name.

The cases considered from other jurisdictions were *GMAC Lease Co. Ltd. v. Moncton Motor Home and Sales Inc. (Trustee of), [2003] N.B.J. No. 140 (N.B.C.A.); Kelln (Trustee of) v. Strasbourg Credit Union (1992) 89 D.L.R. (4th) 427 (Sask.C.A.); Re Lambert (1994) 20 O.R. (3d) 108 (Ont. C.A.); and Gold Key Pontiac Buick (1984) Ltd. v.464750 B.C. Ltd (Trustee of) [2000] B.C.J. No. 1460 (B.C. C.A.).*

The Court seemed somewhat concerned that there was a lack of consistency across jurisdictions in relation to the seriously misleading issue. What is clear from these authorities, however, is that the test, as they saw it, was objective, not subjective.

The Court in *GMAC*, supra, stated it thus (as quoted in *Harder* at paragraph 22):

> As for serial numbered consumer goods, such as cars and trucks, the fact remains that a seriously misleading error in either debtor name or serial number is sufficient to establish invalidity of a registration. Subsection 43(8) of the [PPSA] says so. The fact that a purchaser performs a dual search and obtains actual notice of a financing statement does not alter this legal reality.

In *Kelln*, supra, the Court reiterated that the test was whether a reasonable person would be misled. With respect to mandatory serial numbers, the failure to include it would be misleading as a hypothetical searcher could be someone who had only the serial number to go by. The Court said (again quoting directly from *Harder* at paragraph 23):

> The registering party is required to include in his financing statement the name of the debtor and the serial number for certain types of collateral. Thus the failure to include the serial number when required to do so is seriously misleading. Is the failure to include the serial number on a financing statement where the name of the debtor has been included seriously misleading? The response must be "yes" because the test is objective and not subjective. The test is not whether the particular person using the registry is misled but rather whether hypothetical users of the registry, which would include persons who only have the serial number of the collateral available as a search criterion, would be misled. Thus the conclusion is that the failure to include both of the mandatory registration search criterion where it is required will result in the registration being seriously misleading and render the security interest unperfected.

The other two decisions also support the position that the test is objective, not subjective.

It matters not whether someone is actually misled.

The Court then reviewed *Case Power*.

In the Court's view, the approach was different than the approach in other jurisdictions. *Case Power* came about as a result of a contest between two competing creditors, not between a creditor and a trustee. The facts in that decision were summarized by Justice Cote at paragraph 2 as follows:

> June 8, 1990 Appellant's assignor registers notice of its conditional sales contract over the Volvo loader under wrong debtor name, but correct serial number.
>
> November 27, 1990 Appellant's assignor registers notice of its conditional sales contract over the Case Dozer and Case Rammer under wrong debtor name. It gives wrong serial number for dozer, but correct serial number for rammer.
>
> June 28, 1991 Appellant's assignor registers notice of its security agreement over Case Excavator under wrong debtor name, but correct serial number.
>
> December 2, 1991 First Calgary registers notice of a general security agreement with the debtor under correct debtor name, but with no serial numbers and no specific descriptions of individual items encumbered.
>
> January 8, 1992 Appellant files amending registrations for three items (all but the excavator) correcting the debtor name.
>
> March 2, 1992 First Calgary amends its registrations to give the correct serial numbers and specific descriptions of the Volvo Loader, the Case Dozer, and the Case Excavator.

The Court in *Case Power* had to determine who, as between the two creditors, had priority. They formulated a test to assist in determining when a registration is seriously misleading registration. This is the test Justice Bielby purported to apply in *Harder.*

Interestingly, Justice Bielby stipulates that the test pronounced in *Case Power* is that which was articulated by Justice Cote at paragraph 22:

> In my view, an error in describing a chattel would make a registration "seriously misleading" in *either* of two situations.

> (i) It would likely prevent a reasonable search under a reasonable filing or registration system from disclosing the existence of the registration, *or*
>
> (ii) It would make a person who did somehow become aware of the registration think that it was likely not the same chattel. (emphasis added)

The Court then considered the majority comments made in the reasons of Justice Hetherington and stated that the majority endorsed the test of Justice Cote (which is not correct and will be reviewed later in this paper). Justice Hetherington did, however, articulate some factors to consider when evaluating whether an error is seriously misleading (at paragraphs 70 & 71):

> In my view, whether an error in the serial number of a chattel is seriously misleading or not, must be determined with regard to the facts of the case. The nature of the registration and search system in place at the relevant times is one of those facts. Whether a search using the *correct* serial number of the chattel would have produced information about the security interest in the chattel registered using an *incorrect* serial number, is a second. Whether a search of the debtor's name would have produced this information, is a third. There may be others.
>
> In relation to the dozer, a search using the *correct* serial number produced information about the registration of the appellant's security interest using the *incorrect* serial number. It showed it as a match "closely approximating your search criteria". A search of the debtor's name also produced information about this security interest, as did a search of the name under which the debtor carried on business. In these circumstances, Mr. Justice Côté's first test, as I would amend it, has surely been satisfied.

Justice Bielby then correctly concludes that key to the decision was the first of the two tests had been met as a searcher would have found the Case registration given that it was revealed as an inexact match when the correct serial number was used.

The Court then reviews Registrar Funduk's decision in *Primus*. The facts in that decision are very similar to the facts in *Harder*, the only difference being that there were two incorrect digits in the serial number. According to the reasons in *Primus,* a search using the correct serial number did not reveal the registration at all (paragraph 19). One assumes this means it was not disclosed as an inexact match.

Registrar Funduk applied the test as articulated by Cumming and Wood in *Alberta Personal Property Security Act Handbook*, 3rd ed., p. 369 which confirmed that the test was objective and that the defective search result should be reviewed on its own apart from whether the registration would have been revealed using different criteria (paragraph 1).

Registrar Funduk interpreted *Case Power* to mean that in the case of serial numbered goods, an error in the registration of the serial number which did not result in disclosure of the registration at all was seriously misleading even if the debtor description was accurate.

Justice Bielby disagreed with Registrar Funduk. In her view, his conclusions ignored the express statements of the Court in *Case Power*.

Justice Bielby then considered the earlier Queen's Bench decision in *John Deere Finance Ltd. v. Highview Farms Ltd. (Trustee of) [1996] A.J. No. 840* ("*Highview*"), a decision which Registrar Funduk was critical of. Justice Bielby was of the view that Justice Sanderman's decision in *Highview* was more in keeping with the Court of Appeal's decision in *Case Power*.

In *Highview*, the contest was again between a trustee and a creditor. The issue involved serial number registrations respecting a baler and a tractor. The Court correctly determined that the baler was not a serial numbered good and accordingly, the registration error in the serial number was irrelevant. With respect to the tractor, the Court concluded the error was not seriously misleading as the registration was disclosed on a search of the debtors name. There is no indication as to whether a search using the correct serial number revealed the registration as an inexact match.

It is important to note that the case did not involve consumer goods, it involved equipment.

Justice Bielby preferred the reasoning in the *Highview* decision. She also accepted the submissions of counsel for ATB that where a subsequent purchaser, financier or bankruptcy trustee acquires actual knowledge of the existence of security interest registered under an improper serial number, such an error can not be considered as seriously misleading. It was her view that this interpretation was consistent with the Court of Appeal's decision in *Case Power* and was not precluded by the wording of s. 43(8) of the *PPSA*. In her words (at paragraph 53):

> This interpretation is not barred by s. 43(8) of the PPSA. That section merely states that actual prejudice need not be proven as a precondition to finding a registration error is "seriously misleading". It does not state that actual knowledge cannot offset an error which otherwise might be "seriously misleading".

The Court concludes with the following comments on the result (at paragraphs 56 and 57):

> This conclusion is possibly contrary to the philosophy behind the enactment of the contemporary personal property registration in place in Alberta. As quoted by Registrar Funduk in *Primus* the *Alberta Personal Property Security Act Handbook*, 3rd ed., p. 369 suggests that its authors believed in the sanctity of the registration search, with the result that a serial number error in a security being registered essentially defeats the lender against all parties other than the debtor independent of the results of name searches. Presumably because a name search cannot provide the protections offered by an accurate serial number search the rationale is that only the serial number search should be given any effect at all.
>
> However, that is not the interpretation accorded to the legislation by our Court of Appeal in *Case Power*, nor is it one driven by the actual words found in s. 46 of the PPSA.

The appeal was dismissed.

CRITICAL ANALYSIS

There are three problems with this decision:

1. It relies on cases dealing with non-consumer serial numbered goods as support for the result;
2. It appears to neglect the role of the bankruptcy trustee and the duties of the bankrupt in the process; and
3. It misconstrues *Case Power* with the result that actual knowledge is brought into play making the test subjective, not objective.

First, it is clear from the *PPSA* and its regulations that consumer goods which are serial numbered goods must be registered by way of serial number in order to properly perfect the security interest. For all other serial numbered goods, registration by way of serial number is permissive, but it is not necessary to register by way of serial number in order to perfect the security interest and enjoy priority to a trustee in bankruptcy. It only becomes an issue of priority between competing creditors. This is set out in section 34(1) of the *Personal Property Security Regulation,* Alta. Reg. 95/2001:

> 34**(1)** Where a financing statement is submitted for registration in respect of a security interest in collateral that is serial number goods,
>
> (a) if the goods are consumer goods, the secured party must provide a description of the goods by serial

number in accordance with section 35, and

(b) if the goods are equipment or inventory, the secured party may provide a description of the goods in accordance with section 36 or by serial number in accordance with section 35. (Emphasis added)

The Court relied on the decision in *Highview* as support for the interpretation it applied in this case. The difficulty with that is that *Highview* was not a case involving consumer goods. A closer review of that decision reveals that the case involved a business debtor who dealt in farm implements. The implements involved were a baler and a tractor. These are equipment or inventory. While the Court was quite correct in it's assessment respecting the baler (it was not a serial number good and therefore need not be registered by serial number), it need not have considered the question in relation to the tractor in the manner which it did: the tractor was not a consumer good. As such, it's registration by way of serial number was permissive, not mandatory and as against a trustee in bankruptcy, the tractor need only be described generally in order for the security interest to be perfected. While this aspect of the case was decided on the basis of the seriously misleading test, it need not have been. It is submitted that the interest was perfected in any event for the purpose of the contest with the trustee. The seriously misleading issue on the serial number was irrelevant, although the result was correct.

Accordingly, the value of *Highview* as a precedent for the proposition put forward is questionable.

Second, the decision neglects to consider the role of the trustee and the duties of the bankrupt in the process. The trustee's role and the interplay between the *BIA* and the *PPSA* was thoroughly reviewed by the Supreme Court of Canada in *Re Giffen [1988] CanLee II 844 (S.C.C.) ("Giffen").*

The Court in *Giffen* considered that by virtue of section 71(2) of the *BIA*, upon an assignment into bankruptcy the bankrupt' property vests in the trustee. The Court noted that "property" was defined very broadly in section 2 of the *BIA* to include "every description of estate, interest and profit, present or future, vested or contingent, in, arising out of or incident to property".

The Court determined that the right to use and possess a vehicle did constitute "property" for the purposes of the *BIA* and the trustee, by virtue then of section 71(2) of the *BIA* succeeds to this proprietary right. The Court later affirmed this position in *Royal Bank of Canada v. North American Life Assurance Co. [1996] 1 S.C.R. 352 ("Ramgotra").*

It is on this basis, so says the Supreme Court of Canada in *Giffen,* that the Trustee assumes an interest in the car and can assert a claim to it.

With respect to the applicability of the section 20(a)(i) of the *PPSA*, the Court noted that, beginning at paragraph 38:

The Saskatchewan Court of Appeal explained the theory behind section 20 of the Saskatchewan *PPSA* in International Harvester (at page 204-5). A person with an interest rooted in title to property in possession of another, once perfected, can, in the event of default by the debtor, look to the property head of all others to satisfy his claim. However, if that interest is not perfected, it is vulnerable, even though it is rooted in title to the goods (at p. 205):

> Public disclosure of the security interest is required to prevent innocent third parties from granting credit to the debtor or otherwise acquiring an interest in the collateral. However, public disclosure of the security interest does not seem to be required to protect the Trustee who is not in the position of an innocent third party; rather, the Trustee succeeds to the interest of the bankrupt. In one authority's opinion, Trustees are given the capacity to defeat unperfected security interests because of the "representative capacity of the Trustee and the effect of bankruptcy and the enforcement of rights of unsecured creditors" (R.C.C. Cumming, "Canadian Bankruptcy Law: A Secured Creditor's Heaven" (1994), 24 Can. Bus. L.J. 17 at pg. 27 – 28).
>
> Prior to bankruptcy, unsecured creditors can make claims against the debtor through provincial judgment enforcement measures. Successful claims will rank prior to unperfected security interest pursuant to section 20. Once a bankruptcy occurs, however, all claims are frozen and the unsecured creditors must look to the Trustee in bankruptcy to assert their claims…

The Court in *Giffen* noted and affirmed that a trustee acts in a representative capacity of creditors. Where there is a contest between a trustee and an unperfected security interest, after bankruptcy, the trustee acts as a representative of the unsecured creditors of the bankrupt and asserts the claims of those unsecured creditors to the goods. It is simply a contest between an unsecured creditor and the holder of an unperfected security interest.

In reaching the conclusions in *Harder*, the Court fails to give due respect to the role of the trustee in this process. It fails to acknowledge the representative role of the trustee in a bankruptcy and that it is there for the protection of the interests of unsecured creditors of the bankrupt.

The case also fails to consider the duties of a bankrupt upon filing an assignment into bankruptcy. The bankrupt is required to fully disclose assets, liabilities and securities and must swear a statement to that effect (*BIA*, s. 158). Failure to do so is an offence (*BIA,* s.198). It is the trustee's duty to ascertain these things at the time of the assignment and to take whatever steps post-bankruptcy to gather in the bankrupt's property and administer the estate, including assessments of secured claims (*BIA* s. 135). In every

single bankruptcy case, a trustee should become aware of the bankrupt's secured property and should, if following the duties imposed upon it under the *BIA*, become aware of any issues at all with respect to a secured lender's security and their registrations. Accordingly, in virtually every case of a voluntary assignment into bankruptcy, at least in relation to consumer bankruptcies, the trustee will be aware of issues such as were presented to the trustee in *Harder* and therefore, based on the *Harder* decision, the trustee, once fixed with knowledge, will have to accept the secured claim regardless of defects in the registration. Section 20(a)(i) of the *PPSA* will be irrelevant to any trustees' consideration. If it knows there is security, it will have to deliver it up to the secured creditor.

Third, and perhaps the most troubling, the Court adopts a test of actual knowledge thereby converting the seriously misleading test from an objective one to a subjective one and making Alberta the only jurisdiction in the country where that is so. With the greatest of respect, the Court misconstrued the Court of Appeal's test in *Case Power* as being subjective. This is suggested for two reasons:

1. The test is actually outlined in Madame Justice Hetherington's Reasons, not Justice Cote's. Her Ladyship amends the test as outlined by Justice Cote and omitted the words "under a reasonable filing or registration system" from the first alternative in Justice Cote's test; and
2. The Court at paragraph 12 and 13 of the decision says quite clearly that notice is not an issue:

> The aim of giving notice is not necessarily best served by making priority flow from notice. It can also be accomplished by setting up a registry, making priority date from registration, and letting mortgagees register and shoppers' search. *Furthermore, that system produces much more certainty. What is the first registration is very clear, and when it is not clear, it is usually a question of law. But notice is a difficult fact question which often requires a trial to establish. So even if the respondent is right about the aims of the scheme, the statutory scheme of priority does not make any use of notice as such.*
>
> *Therefore I put no weight on the evidence in the appeal book about who knew of the other parties competing interest, or when.*
>
> *(Emphasis added)*

The Court of Appeal made it clear in *Case Power* that knowledge or notice was irrelevant and ought not to be considered. In other words, the test is objective.

The introduction of knowledge in the context of the *PPSA* is problematic and can only lead to uncertainty and trials, exactly what Justice Cote said the system was to prevent. The result is going to be a much more costly process for determining the validity of

registrations and determining priorities.

This also creates circular priority problems. What if, as an example, an unsecured creditor of the Harders had registered its writ by way of serial number against the correct serial number of the trailer and was otherwise uninformed about the ATB registration error? It could take the position that it was entitled to priority in bankruptcy? Or does that run afoul of the *BIA*?

What of other secured parties who lacked knowledge of ATB's interest? They would have priority to ATB but the trustee would not. It results in the possibility that registrations may be valid against some but not others, priority may be granted to some but not others. It simply makes the system unworkable.

CONCLUSION

The *Harder* decision, should it be accepted as good law, will be unique in Canadian jurisprudence setting Alberta apart from the remaining jurisdictions in this country on this issue. All other jurisdictions apply an objective test. It appears, now, that Alberta will have to apply a subjective test leading to great uncertainty. The Court as well, did not limit its scope to situations involving bankruptcy trustees.

Interestingly, it may be possible, in light of the *Harder* decision, to have circumstances such as those present in the Saskatchewan Court of Appeal case in *Kelln* be decided completely differently here. In that decision, the secured creditor neglected to register a serial number at all. A search by serial number would obviously not reveal the interest but a search by name did. On those facts, applying *Harder*, the secured creditor would be granted priority if the trustee was aware of the secured interest. With respect, that is not the intention behind the *PPSA*, nor, for that matter, it is submitted, was that the interpretation put forward on these particular sections by the Court of Appeal in *Case Power*.

The results should certainly make for interesting times in the insolvency bar, particularly among those practicing in the consumer bankruptcy area.

One final note, an attempt was made to appeal *Harder* to the Court of Appeal. However, there are no appeals as of right under the *BIA*. The Court of Appeal denied leave. For now, *Harder* appears to stand as the law on the subject.