SUMMARY OF CURRENT DOCUMENT	
Name of Issuing Party or Person:	**John Deere Limited**
Date of Document:	**7 February 2003**
Summary of Order/Relief Sought or Statement of Purpose in filing:	**Reply Memorandum of Fact and Law of John Deere Limited to the Interlocutory Application (Inter Partes) of Wells Fargo Equipment Finance Company ("Wells Fargo")**
Court Sub-File Number:	**7:05**

2002 01T 0352

IN THE SUPREME COURT OF NEWFOUNDLAND AND LABRADOR

IN THE MATTER OF
A Court ordered Receivership
of Hickman Equipment (1985) Limited
("Hickman Equipment") pursuant to Rule 25
of the ***Rules of the Supreme Court, 1986***
under the ***Judicature Act***, RSNL 1990,
c. J-4, as amended

AND IN THE MATTER OF
the ***Bankruptcy and Insolvency Act***,
RSC 1985, c. B-3, as amended

MEMORANDUM OF FACT AND LAW OF JOHN DEERE LIMITED ("JDL" OR "DEERE")

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SUBROGATION

General

1. JDL submits that, while the remedy of subrogation is available in a wide variety of situations in order to reverse a person's unjust enrichment, it is not a remedy which a court has a general discretion to impose whenever it thinks it

just to do so. Rather, subrogation arises from the conduct of the parties on well-settled principles and in defined circumstances.

Reference: Goff and Jones, **The Law of Restitution** (5th ed.) (London: Sweet & Maxwell, 1998), pages 120-169, especially at 121.

2. JDL submits that subrogation is not available to Wells Fargo in the circumstances under consideration before the Court for several reasons (discussed more fully below) including the following: Wells Fargo obtained effective security from Hickman Equipment and all that Wells Fargo bargained for; there has been no unjust enrichment of JDL; if there was a conditional subordination letter issued by JDL to Wells Fargo, subrogation was impliedly, if not expressly, excluded by agreement between Wells Fargo and JDL.

3. JDL also submits that subrogation is not available to Wells Fargo in the current circumstances as subrogation would lead to a result inconsistent with the provisions of the Personal Property Security Act, S.N.L. 1998, c. P-7.1 (the "PPSA"). Principles of the common law and equity (including subrogation) do not apply where they are inconsistent with the provisions of the PPSA.

Reference: PPSA, section 66.

Subrogation is Not Available in the Circumstances under Consideration

4. Equity may assist a person whose security proves to be defective. As stated recently in the House of Lords:

"...there is an equitable principle that where a lender advances a sum of money to another person intended to be a secured loan, and the money is used by that person to discharge a debt owed by him to a secured creditor, the lender is entitled to be subrogated to the charge of that creditor if his security proves to be defective." (emphasis added)

Reference: **Banque Financiere de la Cité** v. **Parc (Battersea) Ltd.** [1999], 1 A.C. 221 (H.L.) at para. 44.

5. Similarly, Goff and Jones write:

"A lends money to B. The money is used to discharge C's mortgage over B's land or to buy land from C. In what circumstances will A be subrogated to C's mortgage or to C's unpaid vendor's lien? The problem arises most acutely when B is insolvent and A is attempting to obtain priority over B's general creditors.

It has been said that it is not enough for A to show that his money has been used to pay off B's debt to C. There must be ... something more. Unfortunately, it is not clear from the case law what that "something more" must be. Some judges have regarded the intention of the parties as a matter of paramount importance. Others have not. It appears that two situations must be distinguished. First, A pays off C's mortgage without having made any agreement with B to do so. Here there is a presumption that A intends "that the mortgage shall be kept alive for his own benefit"; he is, therefore, subrogated to C's mortgage. Secondly, A lends money to B and the money is used to pay off C's mortgage or to buy C's land. In this case the real intention of the parties may be critical. If "the true nature of the transaction ... [between A and B] is simply the creation of an unsecured loan, this in itself will be sufficient to dispose of any question of subrogation" to

C's security. Conversely, if the parties intended to create a secured loan, then A will succeed to C's security if no effective security is created by the agreement between A and B. This will certainly follow if the loan agreement between A and B expressly provides for a security. But an express agreement for a security is not essential. "The whole circumstances of the transaction" may also indicate that A intended to take a security over B's property. "The whole circumstances" may include a payment directly by A to C, with B's concurrence; or a loan to B, accompanied by a direction from A that the money should be used to discharge C's mortgage or to buy C's land; or a payment to C, where A had no direct dealings with C and intended to retain his beneficial interest in his money until that interest was replaced by a legal mortgage over B's property. In resolving the question of A and B's intention, the allocation of the burden of proof may be critical. *Paul v. Speirway Ltd* suggests that there is a presumption, which can be rebutted by contrary evidence, that A intended to make a secured loan whenever it can be shown that A's money has been used to discharge C's mortgage or lien over B's property." (emphasis added)

Reference: Goff and Jones, **The Law of Restitution** (5th ed.) (London: Sweet & Maxwell, 1998), at 151-152.

6. Significantly, the ability of A to succeed to C's security (subrogation) is premised on A having itself obtained *no effective security* that can be enforced against the debtor (B). It is in this context that equity will assist.

7. However, this is not the context under present consideration before the Court. On the contrary, in 1999 Wells Fargo did obtain effective security from

Hickman Equipment in units FF0370X080344 ("344") and FF0200X500917 ("917"). This security was precisely the security and the priority ranking for which Wells Fargo bargained. It continued to enjoy that security (and that priority ranking) for over two years, until December 13, 2001. At that time, because the financing statement which Wells Fargo filed under the PPSA failed to comply with the mandatory "transition" requirements of the PPSA, Wells Fargo then lost the benefit of being able to claim a pre-PPSA registration date for priority purposes.

Reference: Decision of Hall J., dated 3 January 2003, in **Interlocutory Application by Wells Fargo Equipment Finance Company** (2002 01 T 0352, Supreme Court of Newfoundland and Labrador).

8. Nevertheless, the security interest obtained by Wells Fargo from Hickman Equipment *remains* effective security against Hickman Equipment (and its trustee in bankruptcy). Wells Fargo has simply lost the priority position vis-à-vis other secured parties which it previously enjoyed. This loss of its priority position is directly and entirely a consequence of its own failure to maintain the priority position it had, by failing to comply with the mandatory "transition" requirements of the PPSA.

9. The carelessness of Wells Fargo – in failing to maintain the priority position it had – needs to be distinguished from situations where carelessness occurred at the time of the payment or loan transaction or in connection with the purported taking of security. Courts have in such situations indicated that carelessness in failing to obtain the intended security in the first place does not in itself necessarily mean that subrogation will not be available. However, this is not the present situation. On the contrary, Wells Fargo obtained at the outset precisely the security and the priority ranking for which it bargained,

and it was only as a result of its *subsequent* carelessness years later that it lost the priority position it had obtained at the outset. JDL submits that subrogation should not be available to Wells Fargo to cure such subsequent carelessness in failing to maintain its priority position.

Reference: **Banque Financiere de la Cité** v. **Parc (Battersea) Ltd.** [1999], 1 A.C. 221 (H.L.) at paras. 34 and 52.

10. This is not a case where a lender made a payment on the expectation that it would acquire a security interest with a priority ranking but, for some reason, never acquired such security interest. Subrogation may be available in such instances.

Reference: **Coupland Acceptance Ltd.** v. **Walsh** [1954], S.C.R. 90;

Re Mutual Trust Co. v. **Creditview Estate Homes Ltd.** (1997) 34 O.R. (3d) 583 (Ont. C.A.).

11. Further, JDL submits that the question is whether JDL has been enriched, whether any such enrichment has been at the expense of Wells Fargo, and, in addition, whether any such enrichment is "unjust". There has been no unjust enrichment. It is not "unjust" for JDL to receive payments of indebtedness owed to it by Hickman Equipment, nor is it "unjust" in the circumstances for JDL to enforce the security agreement which it specifically bargained for in the John Deere Security Agreement – Inventory.

12. JDL specifically bargained with Hickman Equipment for a security interest in, *inter alia*, each of units 344 and 917. That security interest in each of those units was to secure the total debt owed by Hickman Equipment to JDL. JDL's security interest pursuant to the John Deere Security Agreement – Inventory

and other security documents is referenced in the Final Determination of the Trustee in respect of the claims of JDL (the "JDL Final Determination"). More specifically, the Trustee allowed JDL's claim to a security interest in "paid for goods" including each of units 344 and 917 as security for the total debt owed by Hickman Equipment to JDL of $3,591,153.71 (as at March 13, 2002).

Reference: Affidavit of Bruce C. Grant, sworn 7 February 2003, JDL Final Determination, in particular, sections 2, 9B and 17, Exhibit "J".

13. It is common for a supplier of inventory, such as JDL, to bargain for security in a unit to secure indebtedness in addition to the debt relating to the purchase price of the specific unit itself (sometimes such security is termed "cross-collateralization"). Wells Fargo's security documents, upon which it relies to claim a security interest in units 344 and 917, also claim cross-collaterization.

14. This is not a question of JDL being "paid twice" for the same unit. Rather, this is a matter of giving effect to contractually bargained for cross-collateralization, bearing in mind that some units and equipment for which JDL is unpaid have been sold-out-of-trust (and the whereabouts is uncertain). JDL will suffer a very substantial shortfall following the distribution to it of auction proceeds from the sale of assets of Hickman Equipment.

Reference: Affidavit of Bruce C. Grant, sworn 7 February 2003, JDL Final Determination, Exhibit "J".

15. It is not "unjust" for JDL to assert, and rely on, the statutorily mandated priority rules of the PPSA. Those rules provide predictability and certainty in a wide range of commercial and other dealings.

16. In the circumstances, the onus should be on Wells Fargo to make out a case that any enrichment of JDL is "unjust". **JDL submits that Wells Fargo has failed to make out such a case.**

Reference: **Banque Financiere de la Cité** v. **Parc (Battersea) Ltd.** [1999], 1 A.C. 221 (H.L.) at para. 31.

17. JDL further submits that subrogation may be excluded or modified by contract, and that subrogation should not be applied to override the manifest intention of the parties.

Reference: Goff and Jones, **The Law of Restitution** (5th ed.) (London: Sweet & Maxwell, 1998), at 126;

G.H.L. Fridman, **Restitution** (2nd ed.), (Toronto: Carswell, 1992) pages 398-416 and especially at 399.

18. When third parties (such as Wells Fargo) provided financing to Hickman Equipment with respect to a unit, JDL would sometimes issue to the third party, upon request, a form of conditional subordination letter which made it clear that JDL retained its existing security interest in the unit but would subordinate such security interest in the unit *provided* that certain specific conditions were met (including conditions relating to the prior-ranking position of the third party's security). There is nothing in such letter that resembles any "transfer" of JDL's rights or that supports subrogation. Indeed, the conditional subordination expressly provided in such letter is inconsistent with subrogation.

Reference: Exhibit D, Affidavit of Douglas A. Dicker, sworn 31 May 2002.

19. Such subordination letters are effective between the parties according to their terms. The manifest intention in such letters is that JDL retains the full benefit of all the security it has bargained for except only to the extent that the terms and conditions in such letters are met. Even if such terms and conditions are fulfilled, JDL retains its security interest in the unit. The security interest that JDL seeks to enforce in priority to Wells Fargo is the security interest specifically retained by the terms of the subordination letters and JDL is seeking to enforce such security interest in priority to Wells Fargo specifically in the circumstances contemplated by the letters (ie. when Wells Fargo has lost its priority).

Reference: PPSA, section 41(2).

20. In the present instance, there is a lack of evidence and, therefore, uncertainty as to whether JDL issued any such subordination letter to Wells Fargo, although Wells Fargo seems to contend that JDL did so with respect to unit 344. To the extent that such letter was in fact issued, subrogation is not available to Wells Fargo for the additional reason that it was impliedly, if not expressly, excluded by the terms of such letter.

Subrogation in the Circumstances Under Consideration is Inconsistent with the Provisions of the PPSA

21. Even if subrogation were otherwise available to Wells Fargo in the circumstances under consideration before the Court (and it is not), subrogation cannot apply because it would lead to a result that is inconsistent with the provisions of the PPSA.

Reference: PPSA, section 66.

22. Wells Fargo has urged that subrogation be applied in a situation where there are two competing secured parties (JDL and Wells Fargo), each with valid security interests in units 314 and 917, so that, in effect, the specific priority provisions in the PPSA relating to the priority of secured parties will be superseded. Specifically, Wells Fargo seeks to reverse the express priority provisions in section 35 of the PPSA relating to the "first to file" priority rule.

Reference: PPSA, section 35.

23. Wells Fargo seeks this reversal despite the fact that it is its own carelessness in failing to comply with the mandatory "transition" requirements of the PPSA which is the cause of its loss of its priority position.

24. Great caution should be exercised before introducing subrogation in the broad manner sought by Wells Fargo into the carefully structured scheme of rights, remedies and priorities which is prescribed in the PPSA.

Reference: J.S. Ziegel and D.L. Denomme, **The Ontario Personal Property Security Act Commentary and Analysis** (2nd ed) (Toronto: Buttersworth, 2000) at pages 267-268.

25. There appears to be only one reported decision in Canada involving subrogation and a *Personal Property Security Act*. That is the recent decision in Ontario: *Re N'Amerix Logistix Inc.* (2001) 57 O.R. (3d) 248 (Ont. S.C.J.) ("*N'Amerix*"). That case involved a situation where a creditor had failed to

properly perfect its security interest and, after the bankruptcy of the debtor, the debtor's trustee in bankruptcy challenged the effectiveness of the security.

Reference: **Re N'Amerix Logistix Inc.** (2001) 57 O.R. (3d) 248 (Ont. S.C.J.).

26. It is one thing to apply subrogation in a case such as *N'Amerix* where the issue pertained to an unperfected security interest which was otherwise not effective vis-à-vis the debtor's trustee in bankruptcy. It is another matter entirely to apply subrogation where, as urged by Wells Fargo, the result would be to alter the specific priority provisions in the PPSA relating to competing secured parties.

27. The *N'Amerix* case can (and should) be distinguished on a number of fundamental grounds. First, it was clear in *N'Amerix* (and so held) that the debtor (and the debtor's trustee in bankruptcy) would receive an unbargained for "windfall" if subrogation were not available because the creditor who paid the money would have *no effective security* to enforce against the debtor's trustee in bankruptcy. In contrast, Wells Fargo has effective security that can be enforced against Hickman Equipment and its trustee in bankruptcy.

28. Secondly, there is no indication in *N'Amerix* of any priority contest between competing secured parties. In *N'Amerix* there seems to have been no dispute between the bank and the paying creditor and, in fact, the bank was not a party to the motion. This is to be contrasted with the situation in the present application where there clearly is a priority contest between competing secured parties.

Reference: **Re N'Amerix Logistix Inc.** (2001) 57 O.R. (3d) 248 (Ont. S.C.J.) at para. 51.

29. Thirdly, there is an indication in *N'Amerix* that the intent of the arrangement made between the debtor, the bank and the paying creditor was that the paying creditor would have the "benefit of the security which BNS [the bank] held over the receivables of N'Amerix ...". In the case before this Court, on the contrary, there is no indication of any such intent on the part of JDL that Wells Fargo would have the benefit of the JDL security over the units in question and, if anything, the intention manifested in the conditional subordination letter drafted with respect to unit 344 is clearly to the opposite: JDL would retain at all times its security interest in the unit and Wells Fargo would have to obtain its own prior-ranking security.

Reference: **Re N'Amerix Logistix Inc.** (2001) 57 O.R. (3d) 248 (Ont. S.C.J.) at para. 30.

30. Finally, in *N'Amerix* the Court was asked to address the provision in the Ontario PPSA which provided, in effect, that, until perfected, a security interest is not effective against a trustee in bankruptcy. It was in this context that the Court considered section 72 of the Ontario PPSA, a section which is similar to (but not identical to) section 66 of the PPSA. Since it was undisputed in *N'Amerix* that the bank held a perfected security interest (and since it was such interest to which the paying creditor wished to be subrogated), the Court concluded that subrogation in that particular instance would not lead to a result inconsistent with the provisions in the Ontario PPSA.

Reference: **Re N'Amerix Logistix Inc.** (2001) 57 O.R. (3d) 248 (Ont. S.C.J.) at paras. 39 and 50.

31. However, a very different situation exists in the present Wells Fargo application. Here there is no trustee in bankruptcy challenging the registration of Wells Fargo, saying that it is unperfected. On the contrary, it is undisputed that Wells Fargo has a valid security interest which is perfected. Instead, the issue in the present application involves the priority of two competing secured parties, each with a valid and perfected security interest and each claiming units 314 and 917 as collateral. The position urged by Wells Fargo with respect to subrogation would, if accepted, fundamentally alter the priority which would otherwise follow from the priority provisions in the PPSA. Specifically, it would lead to a result totally inconsistent with the express priority provision in section 35 of the PPSA relating to the "first to file" priority rule.

Reference: PPSA, section 35.

32. Quite apart from the specific priority rules of the PPSA, there are a number of other PPSA provisions which could be materially affected by the introduction of subrogation into the structure of the PPSA. It is not possible to predict the full range of implications. However, it is noted that *N'Amerix* seems to suggest that the definition of "secured party" encompasses a person who holds a security interest for the benefit of a person who is entitled to be subrogated. There are numerous references to "secured party" in the PPSA and numerous references to rights and obligations of a "secured party".

33. For example, section 19 of the PPSA contemplates that various persons may require a "secured party" to make available certain information or documentation relating, among other things, to the amount of the indebtedness. The "secured party" must respond. If the bank in the *N'Amerix*

case received such an enquiry, it is problematic whether its reply would state the amount of money owed to the bank only, and not include also the amount which the paying creditor had paid to the bank. If the bank responded by stating only the amount of the indebtedness owed to it (which would seem likely), and not including the amount for which the paying creditor might later claim to be subrogated, it is easy to foresee that the enquiring party could be seriously prejudiced. Other issues might arise as to the rights, if any, of the party claiming subrogation to insist upon receiving notices which are to be addressed to a "secured party" or to insist on having rights and remedies (including rights of redemption) which are available to a "secured party".

Reference: PPSA, section 19.

34. Introducing subrogation into the structure of the PPSA will give rise to uncertainty and unpredictability. Such policy-related issues should be left to the legislature. As stated by one commentator with respect to section 72 of the Ontario PPSA:

> **"It is most tempting to invoke general principles of law and equity when literal application of the Act appears to lead to unjust results or results in a windfall for an undeserving party. This is a familiar dilemma where courts must balance the predictability of black letter rules against the virtues of fairness and justice between the parties. Though it is not a conclusive answer, the judicial conscience can rest more easily where the rules are of statutory origin, as they are in the case of the OPPSA. The Act having been so recently revised, it may be safely assumed that the policy choices were consciously adopted, even if they can lead to apparent unfairness in individual cases. It is better therefore, where the statutory language and policy are**

unambiguous, to leave any changes to the legislature than for courts to embark on piecemeal or uncoordinated changes of their own."

Reference: J.S. Ziegel and D.L. Denomme, **The Ontario Personal Property Security Act Commentary and Analysis** (2nd ed) (Toronto: Buttersworth, 2000) at page 574.

35. In summary, it is respectfully submitted that subrogation ought not be available to Wells Fargo. Wells Fargo fully obtained, at the outset, effective security and the priority ranking it bargained for; it was only due to its own carelessness that it subsequently lost the priority position it had. It is further submitted that applying subrogation in the circumstances under consideration before the Court would lead to a result inconsistent with the provisions of the PPSA and much uncertainty.

36. JDL therefore requests that this Honourable Court dismiss any argument by Wells Fargo that it is entitled to be subrogated to JDL's security in respect of units 344 and 917.

DATED AT St. John's, in the Province of Newfoundland and Labrador, this 7th day of February 2003.

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