

Collateral Matters

A Banking Law Newsletter

AIRD & BERLIS LLP
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A Fixtures FAQ

By Timothy Jones*

Introduction

The law of “fixtures” – items, most commonly equipment, that can be affixed to real property – falls at the intersection of real property law and personal property security law. The friction between these two legal regimes can create frustration and confusion for equipment financiers, mortgage lenders and their counsel.

This article provides a brief, high-level overview of issues that arise for equipment financiers when they finance the purchase of equipment that is subsequently installed on real property. After providing an example of a common priorities conflict involving a fixture, we explain basic principles in this area before answering some frequently asked questions that equipment financiers often have about how their interests may or may not be protected.

An Example of a Fixture Financing Conflict

When equipment or other types of goods are installed on real property, a lender or lessor’s security interest in the equipment can come into direct conflict with any pre-existing security interests on the real property, most commonly in the form of a mortgage.

For example, let us assume:

- a bank has a mortgage over a homeowner’s real property;
- an HVAC company leases a furnace to the homeowner (or sells them the furnace, with payment by way of instalments);
- the furnace is installed in the home; and
- the homeowner defaults under both the mortgage and the furnace financing arrangement.

Who has priority over the furnace – the HVAC company or the bank? Can the HVAC company repossess the furnace or get priority over the proceeds from a power of sale?

Unfortunately, the answer to this question is not straightforward. Generally speaking, the rules depend on:

- (1) whether the HVAC company’s security interest “attached” to the collateral before or after the goods are affixed to the real property; and
- (2) whether, and when, a notice of security interest (“**NOSI**”, also known colloquially as a “**fixtures filing**”) was registered on title.

If the HVAC company has priority over the fixture, it is entitled to repossess the equipment, subject to certain conditions.

Three Core Principles of Fixtures Law

1. If the equipment financier’s security attaches pre-installation, it has priority over existing mortgages.

In our example, if the HVAC company’s interest in the furnace “attaches” before the furnace is installed in the building, the HVAC company (the equipment financier) has priority over the bank (the mortgage lender). (The concept of “attachment” is defined in provincial personal property security legislation, but for the purposes of this brief overview, the reader can assume that attachment occurs when the relevant security agreement is executed by both parties.)

It is helpful to understand the theory behind this rule – it is all about protecting the reasonable expectations of lenders.

The policy reason for giving the HVAC company priority is because the bank would not have expected to have priority over the furnace when it entered into the mortgage because, at that time, the furnace was not part of the real property. Since this security was in the mortgage lender's contemplation when entering into the mortgage, there is no commercial rationale for adding additional collateral to the mortgage – doing so would result in a windfall for the mortgage lender.

For the HVAC company, the opposite is true – it would likely not finance the equipment purchase without having a priority security interest. The law recognizes this commercial logic and protects the equipment financier's reliance on its security interest by prioritizing it over a pre-existing mortgage.

In this way, the law regarding fixture financing has some similarities to the law of purchase-money security interests (“PMSIs”). If you are familiar with this concept, it can help to think of a (properly structured) fixture financing interest as having a PMSI-like super-priority with respect to pre-existing mortgages.

2. If the equipment financier does not file a NOSI, any subsequent mortgage (or new advances made on a revolving credit facility secured by pre-existing mortgage) would have priority.

In a similar way, any new mortgage lender would expect to be able to take priority over all the homeowner's real property unless it has prior knowledge of a security interest standing in its way.

Accordingly, unless the equipment financier files a NOSI in the real property registry (which is deemed to notify all potential mortgage lenders that the property is encumbered by the equipment lender's interest in the fixture), or unless the new mortgage lender has actual knowledge of the equipment lender's security, the mortgage will have priority over the equipment loan or lease.

The same logic applies for new advances made under revolving credit facilities secured by pre-existing mortgages – if those advances are made without deemed or actual knowledge of the equipment financier's security interest, the mortgage lender will have priority over the equipment loan or lease to the extent of the new advances.

3. If the equipment financier's security attaches post-installation, existing mortgages have priority.

An equipment lender cannot “leapfrog” a mortgage lender in priority by taking security in property that is already installed. So, if the equipment lender takes security in a furnace that was already on the property, a pre-existing mortgage lender has priority.

The next section maps out how these principles apply to some common scenarios encountered by equipment financier.

Frequently Asked Questions

A full description of the intricacies of fixtures law is beyond the scope of this short article. However, the following are some questions frequently asked by equipment lenders or lessors under a financing lease:

How do I know whether my equipment is a “fixture” for the purpose of the PPSA?

The common-law definition of a fixture is complex and is subject to a multi-variable test.

To provide an extremely oversimplified, one-sentence version of the test: an object is a fixture if, among other considerations, it is sufficiently affixed to the land by physical means and its affixation is for the purpose of improving the use of the real property or premises as a whole.

The test is nuanced and notoriously uncertain. This uncertainty can be a challenge for lenders, since the potential for creditor recovery can sometimes be completely dependent on whether an item is a fixture or a chattel.

In an example from south of the border, in the ongoing insolvency proceedings involving the predecessor company to General Motors, over \$1 billion in creditor recovery turned on the question of whether the conveyor belts, furnaces and fluid-collecting pits at certain GM automotive plants were properly defined as fixtures or chattels – a question that turns on the degree to which their removal is possible without irrevocably damaging the property, and on the purpose for which such items were installed in the first place.

What else should I know about the definition of a “fixture”?

It is worth noting that “building materials” affixed to real property are excluded from the definition of “personal property” under the PPSA. So, while a single brick sitting in a brickyard is a chattel to which the PPSA applies, it is excluded from the scope of the PPSA once it is laid into a wall.

There is also a distinction between tenant fixtures and landlord fixtures, which can become relevant if the tenant is evicted from the property.

A full discussion of each of these issues is outside the scope of this article, and the question as to whether an item is a fixture or chattel is fact-specific in every case.

Our example of a household furnace is less controversial since furnaces tend to be firmly affixed to the real property and are generally installed as an improvement to the real property. So, we will set aside definitional controversies and turn to the practical value of a fixtures filing.

If I have a security interest in a fixture that has priority, what does it actually do for me?

It is important to understand the limitations of a secured lender's priority interest in a fixture.

An equipment financier with a priority interest in a fixture is not given a right to be paid out from the proceeds if the land is sold, nor does it have an interest in the land. Its only remedy under the PPSA is removal and repossession of the collateral. And even this has limitations – the party seeking to remove the fixture must comply with certain conditions, including but not limited to reimbursing other owners and/or mortgagees for the cost of removal (i.e. any physical damage from the removal process or, alternatively, any diminution in value resulting from the absence of the fixture). These limitations are set out in the applicable PPSA [in Ontario, ss. 34(3)-(7)].

What can I do to protect my priority?

To ensure an equipment financier's security interest has priority over any other interests in the equipment and any interests in the real property, it should take the following three steps:

- Ensure the security agreement is signed before the fixture is affixed to the property;
- Register a NOSI in the provincial real property registry; and
- Register the security interest under the applicable PPSA.

That said, priority over interests in the real property (i.e. a mortgage) can be obtained without the latter step above (PPSA registration). As discussed above, priority over interests in real property is determined based on the timing of attachment, irrespective of registration.

Accordingly, the PPSA registration is useful to protect against situations where the borrower grants personal property security in the equipment to another lender, but does not protect against competing mortgage lenders.

In situations where it is feasible, an intercreditor agreement is recommended for total certainty as to priorities.

So if I do those three things, I can be confident in my priority?

Even if the security agreement is signed prior to the equipment's installation, a NOSI is registered on title immediately and a PPSA registration is filed, an equipment financier still may not have total certainty that a priority dispute with a mortgage lender would end to the equipment financier's satisfaction.

This is because if the priority of the equipment supplier's security is challenged in a court proceeding, you will need to (among other things) prove that your security interest attached prior to installation. Proving the timing of attachment can be tricky and requires evidence as to the factual circumstances involved. Gathering this evidence and arguing about it in court can prove expensive, to a level that can outstrip the value of your security when the fixture is not a high-value item.

Because of this, an intercreditor agreement with other creditors who have an interest in the relevant equipment or the real property is the optimal way for all parties to have true certainty over their respective priorities.

I did my fixture filing correctly and I have priority over the real property. The homeowner is selling the house. What are my remedies?

As briefly discussed above, your security interest does not entitle you to any portion of the purchase price. If the notice and reimbursement provisions of the PPSA are followed, you can repossess the equipment. However, in many cases, the cost to repair the damage to real property can exceed the value of the collateral, so a negotiated payout is often the best solution for everyone.

The new homeowner can also assume the lease and continue to make payments.

I didn't register a NOSI, or my security interest attached after the equipment was affixed to the property, and now a mortgage on the property has priority over me. What can I do?

An intercreditor agreement with the mortgage lender would be the only option (where it is possible to negotiate one). The equipment financier cannot seek to have the equipment detached for the purpose of repossession unless it has priority over other interests in the real property.

I didn't register a NOSI, and the homeowner sold the house to a third party with the fixture still inside it. Do I still have any rights in the fixture? Can I repossess the equipment?

Unless the new homeowner adopts the lease, the answer is no. There is no way under the PPSA to force the new homeowner to adopt the lease.

While you may have remedies against the homeowner that sold the house, if you did not register a NOSI before the real property was sold to a third party, as long as that third party was unaware of your security interest, it has priority over you under the PPSA. More importantly, under common law principles, the third party would take the fixture free and clear of your interest in it, so your security interest in it would be negated.

I registered a NOSI, but not until after the equipment was installed. Does the NOSI have any value to me?

Yes, it gives you rights against any subsequent persons who take a security interest in the real property, such as a second mortgage registered on title after your NOSI was registered. Where there is significant equity in the property, this can be valuable.

Why is this all so frustrating?

Fixture financing creates conflicts between principles of real property law (which are centuries old) and personal property legislation (which, although newer, is often criticized for being out of touch with the needs of entrepreneurs). Courts have had trouble reconciling issues related to fixtures in a principled and accessible way.

As a result, where the value of a fixture financing is significant and there are other creditors with interests in the real and/or personal property, an intercreditor agreement is the best way to ensure certainty over priorities for all involved.

For lower-value items, the cost of securing priority (and, where the debtor is a consumer, the public relations sensitivities that may be involved with your company putting a lien on the individual's title) must be balanced with the benefit of potential recovery on default.

In either case, although the cost-benefit analysis is ultimately a business question, legal advice can help you navigate this tricky area and develop the best approach to financing these goods.

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