STR | Secured Transactions Law Reform Project

DISCUSSION PAPER SERIES:

PRIORITIES

PROFESSOR DUNCAN SHEEHAN

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PRIORITIES

This paper builds on the Secured Transaction Law Reform Project's April 2016 Draft Policy Paper.[1] One of the core aspects of a modern secured transactions law was identified as a set of clear priority rules "based on rational distinctions and at its core a rule that priority between registered interests is by date of registration." (para 1.3). The paper deals with priority issues properly so-called in part I and the taking free issues in part II. In Part III we highlight some changes in the law if asset finance/ retention of title clauses were re-characterised.

There then follow four appendices. Appendix A outlines the different requirements in different jurisdictions for the value required to be given for the taking free rules and the disqualifying knowledge requirements and provides a comparative analysis. Appendix B provides a comparative analysis of the approaches to priority and taking free as they relate to unperfected interests and appendix C provides a comparative analysis of the priority rules as between retention of title financiers and receivables financiers. Finally, appendix D provides a comparison of the different registration requirements for purchase money security interests to gain super-priority.

1 Priorities

1.A PERFECTED SECURITY RIGHTS SHOULD TAKE PRIORITY OVER UNPERFECTED

Attachment refers to the process whereby the security becomes effective between the two parties – grantor and creditor. Perfection refers to the process by which it becomes binding on third parties. Essentially the point of the exercise is publicity – the register should be capable of being relied on; if it is not on the register and you cannot see another in possession or control the security is not binding on you.

All jurisdictions agree that perfected take priority over unperfected – otherwise there is no incentive to perfect. There are some differences as to whether unperfected interests should

1 https://securedtransactionslawreformproject.org/draft-policy-paper/

be void vis-à-vis the liquidator or simply – as in New Zealand under the Personal Property Securities Act 1999 – have reduced priority. This is a question for the registration policy paper.

1.B UNPERFECTED INTERESTS SHOULD RANK BY ORDER OF CREATION OR ATTACHMENT AS BETWEEN THEMSELVES

The general principle here – and in point 3 - is one of first in time prevails. With no date of registration, the only date left to use is that of attachment.

The first in time to register should apply as a default priority rule. It should be possible to file a notice prior to the creation of a security interest and date priority from filing.

Note that this will change the law. The 21-day rule will be abolished enabling a creditor becoming a chargee to advance funds without being concerned that another prior created interest could be registered later and take priority. Secondly, whereas today fixed charges would take priority over floating (negative pledges are now registrable which might seem to change the rules, but the party must have actual notice to be bound under *English and Scottish Mercantile Investments v Brunton*[2] and in any case constructive notice of the charge is not notice of specific restrictions under it), the first to file succeeds here. Thirdly, if assignment of receivables is included – and there is general support for some sort of registration scheme - in the registration scheme the rule in *Dearle v Hall*[3] is displaced. A separate paper is being prepared on receivables, although the analysis does not significantly differ depending on whether non-registration leads to nullity of the assignment or merely reduced or deferred priority.

A separate paper is being prepared on the details of advance filing and registration, but on the assumption advance filing will be possible, WGB believes that priority would date from the filing not the creation of the interest. Person A files a financing statement/notice of the proposed interest on Day 1. Person B files their security interest on Day 2. On Day 3, Person A's transaction completes and their security interest is created. A will have priority. Two related points should be noted.

The default priority rule provides the first-to-file creditor with a powerful priority position. A bank taking a charge over the whole or almost all the assets of the company is put in a quasi-monopoly position. It is quite off-putting for future potential creditors to see such a powerful charge potentially leaving them nothing. Currently they could take a fixed charge or a legal security right such as a mortgage to obtain priority – whether the mortgagee takes priority depends on your view of *Wilson v Kelland*[4] though. That option is unavailable under a unitary security interest. Secondly, the implication is that the tacking rules under the Law of

2 [1892] 2 QB 706.

3 (1823) 1 Russ 1, 38 ER 475.

4 [1910] 2 Ch 306.

Property Act 1925 would be abolished, and this is proposed by the April 2016 Draft Policy Paper at para 3.14. David Richards LJ said in *Re Black Ant Co*[5] the tacking restrictions are aimed at protecting second and subsequent chargees. In other words, they are aimed at that monopoly position. These two points mean that we need some sense of how that monopoly position should be broken.

1.C WGB ACCEPTED PMSIS, PURCHASE MONEY SECURITY INTERESTS

A purchase money security interest is a security interest taken to secure payment of a debt incurred (either to the seller or a third party lender) to obtain the asset over which the security is taken. There are two types of pmsi: sale pmsis and loan pmsis. Under current English law a retention of title clause secures the payment of the purchase price to the seller by allowing the seller to retain ownership until he is paid. If included in the scheme, they could be re-characterised as security rights (sale pmsi). That is – for the purposes of the statute **and only for those purposes** a retention of title clause would be treated as security so title would be treated as having passed to the buyer who grants a security to the seller. In the USA (with the exception of software) pmsis can only exist in goods, but there seems little reason why they should not exist in IP rights as well if the debtor borrows to acquire a patent or patent licence, and UNCITRAL have included pmsis over IP rights in their model law (Article 38).

1.C.i *Super-priority of pmsis against other security interests in the original asset.*

There should be pmsi super-priority. The creditor – a retention of title creditor for example – has priority over earlier non-purchase money creditors because he provided new value to the business. It was noted in the April 2016 Draft Policy Paper (para 3.13) that consideration needs to be given to whether and how a previously registered secured creditor should be notified of the pmsi. There is no logical requirement for notification. The policy question to be answered here is whether and to what extent the prior registered creditor should be expected to monitor the activities of the debtor through periodic checks of the register. It may be that whether it is reasonable to expect a prior creditor to pick out through monitoring a subsequent pmsi will depend on what type of collateral that pmsi has been taken over. It may not be possible to expect a prior creditor to notice a pmsi over fast-turnover assets such as inventory.

The Law Commission's scheme requires that where the interest is in inventory the secured creditor must give notice in writing to anybody who has filed a financing statement over the collateral to say that he will have a pmsi in the collateral prior to the debtor's taking possession of the asset. The notice would describe the inventory over which the pmsi will be held by item or kind. In Australia, Section 62 of the Personal Property Securities Act 2009 (Cth) does not require notice to be given although it does require that registration of the pmsi have taken place at the time the debtor takes possession of the goods and that the registration state that it is a pmsi. The question is one of the balance of convenience – to

5 [2016] EWCA Civ 30.

what extent do we expect prior registered creditors to monitor the register (or to monitor their debtor more generally) vs the extent to which new creditors can be expected to proactively notify prior creditors, or the extent to which retention of title financing (which would under a PPSA system count as a pmsi) is so common that the second creditor can be expected to have anticipated it. The requirements for capital pmsis are less stringent but require registration within 10 days of the debtor's taking possession of the goods, under the Law Commission's scheme, to obtain super-priority. In Australia the period allowed for registration after the debtor takes possession or the security attaches is 15 business days; again the registration must state the security is a pmsi. The choice of period should depend on what is reasonable given industry practice. A survey of the different approaches in the various PPSAs is included in the appendices, but one issue to be considered is that raised in Whittaker's review of the Australian legislation[6] where he questions whether the pmsi creditor will always know when the debtor takes possession of the asset.

The City of London Law Society has indicated its opposition to re-characterisation; however, a registration and priority system might be set up without re-characterisation being required. Even if retention of title devices were not included in the system, consideration would still be needed to the inclusion of pmsis because loan pmsis (where I borrow from the bank for the purpose of acquiring the asset) could still be recognised. Currently no distinction is made between security over assets where the money is borrowed from a bank to finance the acquisition of those specific assets and where there is no such agreed purpose behind the loan. Arguably the policy justification for pmsi super-priority still holds in cases where the loan is for the purchase of the assets and the use of the money to purchase the assets was required in the sense that they would not have been acquired otherwise. Proving the link would, however, be more complex than in the case of sale pmsis.

1.D PRIORITY OF PMSI HOLDERS AGAINST RECEIVABLES FINANCIERS

Imagine retailer A sells goods subject to a retention of title clause. The beneficiary of the RoT clause (B) – the provider of the credit, can trace his interest into the proceeds of sale under a PPSA, but A has previously factored his book debts to receivables financier C. C should have priority over B. The justification for protecting the invoice factor is that he cannot protect himself from future pmsis with super-priority. The consequent commercial risk is said to be too great. In Ontario there is general pmsi super-priority over receivables as well (Personal Property Security Act 1990 (Ont) section 33), but the approach is not universally accepted even in Canada. For instance, Section 34(6) of the Personal Property Security Act 1993 (Sask) provides that in Saskatchewan a prior perfected non-purchase money security in accounts has priority over a pmsi in the accounts as proceeds (but this does not extend to a bank deposit account by subs (7)).

There are two possible options for extending pmsi super-priority – either specific receivables can be linked to specific goods sold by the pmsi debtor or there is a general extension into

6 B Whittaker, A Review of the Personal Property Securities Act 2009. Final Report (February 2015) 322-323.

any debt due. The latter is likely to render receivables financing non-viable in many cases. Even in cases where there is specific extension into associated debts only difficulties arise – including the difficulty of reliably being able to engage in the required tracing exercise. The same is true where pmsi priority is sought to be extended into products, where goods are commingled, processed or manufactured. Attempting to disentangle this for the purposes of deciding where pmsi super-priority lies could become too complex.

In Australia priority also extends to subsequent invoice factoring arrangements if the factor gives a statutory notice to the prior pmsi holder (Section 64 of the Personal Property Securities Act 2009 (Cth)), but this seems a step too far. A survey of the different approaches in the various PPSAs is included in the appendices.

1.E SUPER-PRIORITY FOR CONTROL?

The Law Commission argued that security perfected by control should have priority over security perfected merely by filing. A separate paper is being produced on financial collateral, but if control is accepted as a perfection mechanism over other assets than financial collateral, super-priority needs to be considered in that context also (as for letters of credit under Sections 28-29 of the Personal Property Securities Act 2009 (Cth)) and a separate policy paper may be required here.

1.F POSSESSION

WGA has concluded that registration should be required in cases of security interests over goods; ie possession should not be a perfection mechanism, but that for some documentary intangibles possession should suffice.

The proposal of WGA that possession not be a perfection mechanism is likely to be a controversial one. This section is therefore divided into two. Firstly, we examine the position should the proposal not be adopted and then if it is.

If possession remained a perfection mechanism: currently under English law a pledge or contractual lien is a common law security interest, not an equitable interest. They are not registrable on the Companies Register, and the priority position is therefore unclear. If possession is taken under a pledge of an asset subject to an equitable charge, the pledgee will have priority if he is a bona fide purchaser for value. This will depend on whether we think he has constructive notice of the charge, which in turn depends on whether he can be reasonably expected to search the register. This is unclear and the 2013 reforms have not adequately clarified the law. One argument is that a person who does not need to register should not be expected to do so and therefore the pledgee does not have constructive notice. The flipside is that on taking a security interest, where normally (if it were a charge) a search would be carried out, the creditor should always make a search; the effect of not requiring search is to unduly privilege pledges. If the first argument is correct, priority is reversed under the proposed rule that priority depends on whichever is first possession or registration. If the second is correct, the law does not change but is made significantly clearer.

If possession is no longer a perfection mechanism: the law above no longer applies. A party in possession of an item, but who has not registered his security will not have a perfected security and so points 1 and 2 apply. All perfected securities rank in priority as do prior unperfected interests.

However, WGA did suggest that for some documentary intangibles possession should remain. This is to protect the marketability and negotiability of such instruments. Bills of exchange are decreasing in importance, but for expository purposes it is useful to draw on them because it is a feature of bills of exchange law that a holder in due course can by Section 29(3) of the Bills of Exchange Act 1882 obtain better title than the transferor. The justification for this is to improve their marketability. Essentially they are to be treated like cash. The logic is that one who takes possession of a negotiable instrument takes free of defects in title, and so a security holder who takes possession should have priority over previous secured creditors if he takes for value and without having knowledge of those prior security interests. In effect possession, where it does act as a perfection mechanism, provides for super-priority over prior registered security.

1.G PRIORITIES AGAINST NON-SECURITY INTERESTS

This has also not been discussed and depends on the characterisation of the security interest. With the agreement that there should be only one security interest, for the purposes of the reform we will need to decide whether that interest is legal or equitable as against non-reformed interests such as eg *Quistclose* trusts (explicitly excluded by the Australian legislation) or assignments of non-receivables.

Two models:

1. CLLS model involves retaining the distinction between legal and equitable charges for the purposes of priorities against non-code interests.
2. The Canadian model characterises the PPSA interest as a legal (statutory) charge for such purposes.

The Canadian model changes the priorities in some contexts. In *iTrade v Bank of Montreal* for example iTrade Finance advanced funds to a company controlled by a fraudster. As a victim of fraud iTrade had a constructive trust, but some of the assets had been pledged to Bank of Montreal, which therefore had a security interest under the PPSA prior to the point at which iTrade rescinded the transaction. Bank of Montreal was deemed to be a bona fide purchaser for value – of a legal interest - taking in priority to the equitable interest in iTrade. A pledge is a legal security interest at common law in England so the priority position would be no different on those facts, but we can imagine that the priority position may be different if the Bank of Montreal had an equitable charge (previously subject to the prior constructive trust), now promoted to a legal interest. This is the case of *Bank of Montreal v Innovation Credit Union.*[7] The bank had a federal Bank Act security. Because of the doctrine of federal paramountcy in Canada the provincial PPSA could not affect the Bank Act security's validity. ICU had a prior but unperfected PPSA right. As against other PPSA rights an unperfected right is vulnerable, as we will see. The Supreme Court of Canada held that the provisions of the

7 [2010] SCC 47, [2010] 3 S.C.R. 3.

Bank Act 1991 were based on property law and so the Bank's subsequent right was subject to ICU's right on the basis of nemo dat; essentially a first in time rule was applied. The Saskatchewan Personal Property Security Act 1993 created a statutory interest in the nature of a legal (ie common law) fixed charge, albeit with a licence to deal. Importantly the PPSA did not say in Section 20(2) that an unregistered interest was void, unlike the current English Bills of Sale legislation, merely that it was ineffective against specific categories. It did not therefore matter as against the Bank Act interest that the charge was unperfected. Perfection was only relevant within the confines of the PPSA system and so, despite its unperfected nature, the PPSA interest took priority over the Bank Act security. A related case is *Radius Credit Union v Royal Bank of Canada*[8] where the question related to priority over after-acquired property. RCU had executed a General Security Agreement over all present and future property under the provincial PPSA. The bank then took a Bank Act security. The Supreme Court held that the bank – on the principle of nemo dat – could take no better title than the debtor. Like a floating charge, the GSA, created prior to the Bank Act interest, attached automatically to future assets, acquired subsequent to the grant of the Bank Act interest. The GSA related back in priority terms to the date of the agreement,[9] so the bank's security was over an asset already subject to the GSA. Radius had priority vis-à-vis future assets falling into the scope of the agreement.

By contrast, the CLLS model attempts to retain the current law as far as possible. The disadvantage of the CLLS model is that there are two non-possessory charges not just one. While the Canadian model changes the law, it also provides an incentive to use PPSA interests and not to try to use other devices excluded from the scope of the legislation. This could be considered an advantage in that it encourages use of the new regime and – if that regime is thought to encourage access to credit – will in turn foster increased access to and availability of credit at less cost than at present. This is a policy driver of lesser importance to the CLLS as it deliberately eschews re-characterisation and treats title based finance devices as lying outside the scheme. However, it seems difficult to exclude the possibility of equitable charges. Charges over equitable property would presumably have to be equitable, which raises a question as to the characterisation of a case where a charge is taken over title to all assets of the company – both legal and equitable title.

2 "Taking Free"

2.A WHEN SHOULD A BUYER TAKE FREE OF A REGISTERED SI?

That the chargee is authorised to sell the asset is the obvious case – outside this scenario the basic question is who is the cheapest loss avoider? Put differently, when can the buyer be

8 [2010] SCC 48, [2010] 3 S.C.R. 38.

9 Ibid [34]; under current law this equitable relation-back would be by way of *Re Lind* [1915] 2 Ch. 345. See also on the nature of Bank Act and PPSA security interests *Royal Bank of Canada v Sparrow* [1997] 1 S.C.R. 411.

reasonably expected to search the register? This will depend on the type of asset in question and the type of transaction in question. Usually in the commonwealth PPSAs "taking free" provisions are expressed in terms of the buyer being able to take free if they provide value or new value and are disqualified from doing so if they hold a specified degree of knowledge. Exactly how much knowledge should disqualify a buyer, and what type of value should be required still needs to be determined. A comparative appendix examines the relationship between value and knowledge requirements in different jurisdictions.

2.A.i *Goods*

If the sale or transfer is in the "ordinary course of business" the purchaser should take free unless at a minimum the buyer has actual knowledge that the transaction is in breach of the security interest. Otherwise you would inquire as to whether I had authority from a chargee and commerce would clog up. Different jurisdictions do, however, take different views about how much knowledge is required to disqualify a purchaser or lessee.

This is because there is another policy imperative in play. That policy imperative is the need to protect ownership or security of title. Essentially, it is important that the owner of a property right in an asset not in a position of risking that property right. If a security right were too vulnerable to purchasers this might deter lenders from lending, or lead them to put up the price of credit to offset the additional risk. The logic of the exception is that even if you know of the security you should not enquire as to whether authority exists and so if value or new value is given the recipient should have to know that the transfer is not authorised.

Under current English law there is no need for such a rule because if the chargor is able to use the assets in the normal course of business it is a floating charge; the easiest option is to simply take the definition of "ordinary course of business" across from floating charge jurisprudence. The April 2016 Draft Policy Paper suggests at para 3.15 (4.2.j) that buyers of inventory should take free; this is how a PPSA replicates the effects of a floating charge. It may be that buyers of capital equipment should also take free. In *Orix New Zealand Ltd v Milne*[10] the fact the sales of capital equipment were infrequent, a small part of the business and to trade buyers did not matter. There was a good explanation for the sales within the context of the seller's business. One way of dealing with the tension discussed in the previous paragraph would be to ask in what circumstances would the buyer or lessee expect his contracting party to be able to sell the asset? It need not be the case that a buyer would have reason to suspect a sale of capital equipment to be inadmissible. The flipside view is that a sale of capital equipment is never in the ordinary course of business. This view has an important advantage; it is clear and provides a bright line. Nonetheless businesses do dispose of capital equipment as business models change, as new equipment comes on the market, or when it is approaching – but not yet reached – the end of its useful life. It may be unrealistic to see this as outside the norm.

10 [2007] 3 NZLR 637.

Serial-numbered goods could attract a new rule; if a search of the register by reference to the serial number of the goods would not disclose the security and the asset is one that may or must be described by serial numbered the buyer or lessee takes free. Whether a rule like this is needed will depend on the extent to which registration by serial number is allowed. The details of the registration scheme are the subject of another policy paper; no asset-based registration add-on is currently proposed, but this could be revisited.

2.A.ii *Documents*

This rather depends on the type of documents. Goods have intrinsic uses, whereas some documents are designed to be swapped for other things. Bills of exchange – although decreasing in importance – were designed to be swapped for other things and it is therefore important to preserve their negotiability. A holder in due course of a bill of exchange can, as we have seen, by Section 29(3) of the Bills of Exchange Act 1882 therefore take a better title than his transferor. UNCITRAL suggests in their Legislative Guide that the security right in a negotiable instrument be subordinate to the rights of a protected holder under negotiable instruments law, and this is the effect of article 48(2)(a) of the Model Law. A holder in due course would therefore take free of any prior registered security rights, including rights over the proceeds of the instrument.

Section 70 of the Personal Property Securities Act 2009 (Cth) provides that a person who acquires an interest in a negotiable instrument may have priority over a perfected security interest if he gave value for the interest and took possession. Under Section 70(2)(b) the acquirer, if he was acting in the ordinary course of his business in acquiring such instruments, need only prove he did not have knowledge (actual or constructive) that the acquisition was in breach of the security interest. However, if the party is not acting in the ordinary course of his business in acquiring negotiable instruments he needs to have had no notice of the security interest's existence to take free of it. This privileges those who acquire bills of exchange as part of their business of buying such bills, and raises the question of the interaction with the Bills of Exchange Act, because this does not track the holder in due course provisions, and there seem to be minimal additional benefits in treating the very few people who do not purchase bills in their own business differently. One option might simply be to provide that holders in due course take free. The April 2016 Draft Policy Paper suggested a buyer should take free of dispositions of money – thus replicating the current *bona fide* purchase rule.[11]

Historically, English law has not given the same effect to bills of lading. Bills of lading are not therefore negotiable in the same way. While a negotiated bill of lading can transfer the right to take possession of goods the transferee does not receive a better title than the transferor. If the transferor holds the asset subject to a security so does the transferee, unless the sale is in the ordinary course of business. Some jurisdictions, however, allow for documents of title to goods to be treated differently. Under article 7 of the Uniform Commercial Code (UCC), it is possible for a commercial party taking a document of title to

11 No other rule seems workable.

goods by "due negotiation" to be in a better position than a purchaser of the goods; a similar (but not identical) rule is in place under Section 72 of the PPSA 2009. "Due negotiation" requires (article 7-501(a) UCC) the purchaser to purchase the instrument for value in good faith without notice of a competing defence or interest "unless it is established that the negotiation is not in the regular course of business or financing or involves receiving the document in settlement or payment of a monetary obligation." The policy question at issue here revolves around the extent to which bills of lading and other documents are treated as merely documents to be swapped or as representing the goods themselves. The article 7 rule seems designed to protect financiers who are not interested in the goods themselves. The correct policy response therefore seems to depend on commercial practice, which would need to be further investigated.

2.A.iii *Other Assets*

The Australian legislation provides for rules for investment instruments, and intermediated securities. Often these will be financial collateral and therefore dealt with by way of the EU rules. Financial collateral is the subject of a separate discussion paper, but the Law Commission suggested a protected purchaser rule where a purchaser for value who took financial collateral into its own name – including a secured party – with no knowledge that the disposition was in breach of a prior security takes free of the earlier security. The question also comes up around intellectual property law; security interests over intellectual property law will form part of a separate paper.

2.B WHEN SHOULD A BUYER TAKE FREE OF AN UNREGISTERED SI?

The logic of the PPSA scheme suggests that an unregistered (or unperfected) security ought to be ineffective or void against purchasers, perfected security interests and execution creditors. This is because those creditors and purchasers are unable to avail themselves of the opportunity to examine the register and see that the interest exists. They should therefore be entitled to assume it does not. This also goes for temporarily perfected interests (if they are recognised); despite maintaining the secured party's position for a short period of time, they too are undetectable. Importantly, the New Zealand legislation does not render unregistered security interests void, but merely leaves them at the bottom of the priority queue.

Complete immunity encourages fraud. The Law Commission therefore proposed the purchaser of an asset with an unregistered security should take free unless he had actual knowledge of the existence of the security. The Australian legislation has a more generous rule from the buyer's perspective. A buyer or lessee giving new value takes free of an unperfected interest unless created or provided for by a transaction to which the buyer or lessee was a party (Section 43 of the PPSA 2009). WGB has suggested a rule that a buyer take the collateral free of a prior unperfected interest even where the buyer has actual knowledge of this interest unless fraud can be proven. Imagine that A purchases asset from C which is subject to unregistered charge in favour of B. The charge prohibits sale of the asset without B's assent. A knows this, but there is no collusion with C (so C does not know that A knows). One view is if it's not fraud, it's not A's problem that B has in breach of his obligations to C sold the asset. C has an effective remedy – if B is solvent – against B. Another view is that this goes too far and knowledge should suffice – at least knowledge that the transfer was in breach of the security agreement. There is a comparative analysis of different solutions in appendix B.

3 Re-characterisation

The CLLS is, as noted, opposed to re-characterisation, but we should be aware of the different options and their effects. It is easy to assume that the main difference between re-characterisation and the alternative lies in whether the security remedies in any secured transactions law apply to retention of title and other asset finance regimes. However, other changes may apply.

There are several – overlapping - models of inclusion in a Personal Property Security Act. The first is the unitary model; under such a model the debtor (ie the retention of title buyer) is treated as the owner of the goods for the purposes of the statute and the creditor (the seller) is treated as only having a security right. This turns a retention of title clause into an "in substance security interest." The second model is the possession model. The starting point for this model is nemo dat. The Act does not need to be taken as treating the grantor of the security interest as the owner if that is not so at the general law. Consequently, it raises the possibility that transactions might be treated differently because of their form not their substance. One way in which this might be done is to use the current exceptions to nemo dat as the taking free rules. The reasoning here is that in a unitary model where a retention of title debtor sells on, he is treated as owning the asset, so the question asked is whether the buyer acquires title subject to the "in substance security" or not. Under a possession model, the debtor is not treated as the owner because at general law he is not the owner. The question at stake is therefore a rather different one – does the buyer acquire title?

3.A FULL (UNITARY MODEL) RE-CHARACTERISATION WILL TURN SOME OF THE QUESTIONS CURRENTLY DEALT WITH BY NEMO DAT INTO PRIORITY POINTS AND THE RESULTING PRIORITIES ARE REVERSED FROM CURRENT LAW.

Where there are two sales under retention of title terms (*Re Highway Foods*[12]) or two sales and leaseback (*Michael Gerson (Leasing) Ltd v Wilkinson*[13]) the relation between the two is dealt with by way of exceptions to nemo dat under the Sale of Goods Act 1979 – in the case of Gerson it turns on whether there has been delivery for the purposes of Sections 24 and 25(1). A sale and leaseback would be re-characterised under a PPSA as a security interest. This would change the outcome. Currently Emshelf's second sale (and leaseback) to State Ltd is free of Gerson's interest under Section 24 as E counts as a seller in possession. If registered as a security interest, Gerson takes priority as first to file. E would be taken to have granted a security interest first to G and then to S. Under current law, S wins. Under a PPSA G wins.

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12 [1995] 1 BCLC 209.

13 [2001] QB 514 (CA).

This can be justified because S is able to see that G's interest is registered, although the question also arises as to whether the current cost to G of guarding against losing title to a second buyer from E is greater or less than the cost of S potentially being dissuaded from entering a transaction because of its lower priority position, without either raising the cost of finance or entering a priority agreement with G.

3.B NO REGISTRATION OR RE-CHARACTERISATION

The law remains exactly as it is. This is the CLLS position.

3.C REGISTRATION WITHOUT RE-CHARACTERISATION (THE POSSESSION MODEL)

On the face of the matter the law should remain the same; the question is prima facie not does the third party take title subject to the charge, but simply does he get title?

Section 24 of the Sale of Goods Act 1979 provides:

> "Where a person having sold goods continues or is in possession of the goods, or of the documents of title to the goods, the delivery or transfer by that person, or by a mercantile agent acting for him, of the goods or documents of title under any sale, pledge, or other disposition thereof, to any person receiving the same **in good faith and without notice of the previous sale,** has the same effect as if the person making the delivery or transfer were expressly authorised by the owner of the goods to make the same."

Will the fact of registration provide notice to a subsequent buyer of the first sale so that the second buyer is bound by the first buyer's rights? This will depend on whether the second buyer can be expected to search the register – if the second sale is in the ordinary course of business may be not. However, Section 24 (and a similar question arises in the context of Section 25(1)) is not framed in that way so the possibility arises of different sales being treated differently under these rules. This suggests that the nemo dat question should be brought within the scope of the reformed security – and title financing – regime. That itself raises a question – beyond our scope – as to the relationship between the nemo dat rules in such cases and under the Sale of Goods Act 1979.

Nonetheless one advantage of this model may be that it preserves more of the general law than the unitary model outlined in 1. As such it is closer to the model proposed by the CLLS. The disadvantage is (or may be thought to be) that it does treat some transactions according to their form not their economic substance and, therefore, does not as fully reflect the policy behind the Commonwealth legislation.

PROFESSOR DUNCAN SHEEHAN

22ND DECEMBER 2016

Appendix A

This appendix provides a brief comparative analysis of the main taking free rules and the value and knowledge requirements.

Australia (Personal Property Securities Act 2009 (Cth))[14]

Ordinary course of business (Section 46): no value[15] required to be given; transferee or lessee disqualified if he has actual knowledge that the transfer or lease is in breach of the security agreement.

Authorised transfer (Section 32(1)): if collateral gives rise to proceeds… the security interest continues in the collateral, unless either the secured party authorised the disposal or agreed that the transaction giving rise to the proceeds would extinguish the security interest.

Consumer purchase of low value goods for personal use (Section 47): new value is required; transferee disqualified if he has actual or constructive knowledge that the transfer is in breach of the security interest.

Investment instrument where transferor has possession or control (Section 50): value (but not necessarily new value) required; transferee disqualified if he has actual or constructive knowledge of the breach.

Intermediated security (Section 51): value (but not necessarily new value) required; transferee disqualified if he has actual knowledge of the breach.

Bills of exchange (negotiable instruments) (Section 70): value (but not necessarily new value) required; transferee disqualified if he has actual or constructive knowledge of the breach. If the transferee is not carrying out the business of buying such instruments disqualified if he has actual or constructive knowledge of the security interest.

Documents of title (Section 72): value (but not necessarily new value) required; transferee disqualified if he has actual or constructive knowledge of the breach. If the transferee is not carrying out the business of buying such instruments disqualified if he has actual or constructive knowledge of the security interest.

New Zealand (Personal Property Securities Act 1999 (NZ))

Ordinary course of business (Section 53): no value requirement included; transferee disqualified if "knows" the transfer is in breach of the security arrangement.

Authorised Transfer (Section 45(1)): a security interest in collateral that gives rise to proceeds, continues in the collateral, unless the secured party authorised the dealing.

14 The Australian position has been criticised for having no overarching rationale.

15 Whittaker (n 5) 281-283 has produced tables suggesting reforms to the current Australian rules; in particular, he argues that new value be required in ordinary course of business cases.

Low value consumer goods for domestic use (Section 54): new value required; transferee disqualified if he has knowledge of the security interest.

Negotiable Instrument (Section 96): value required; transferee must take possession and have no knowledge of the security interest.

Investment security (Section 97): value required; transferee must take possession and have no knowledge of the security interest.

Negotiable document of title (Section 99): the interest of a holder of a negotiable document of title has priority over a perfected security interest in the document of title if the holder gave value for the document of title; and acquired the document of title without knowledge of the security interest.

Ontario (Personal Property Security Act 1990 (Ont))

Ordinary course of business (Section 28): a buyer takes "the goods in the ordinary course of business takes them free from any security interest therein given by the seller even though it is perfected and the buyer knows of it, unless the buyer also knew that the sale constituted a breach of the security agreement."

Section 28(2) contains a corresponding provision for lessees.

Negotiable instruments (Section 29): the rights of a person who is (a) a holder in due course of a bill, note or cheque within the meaning of the Bills of Exchange Act (Canada); or (b) a transferee from the debtor of money are to be determined without regard to this Act.

Essentially the Bills of Exchange Act trumps the Personal Property Security Act.

See also Section 28(4): a purchaser of collateral that is an instrument or negotiable document of title has priority over any security interest therein perfected by registration... if the purchaser,

(a) gave value for the interest purchased;
(b) purchased the collateral without knowledge that it was subject to a security interest; and
(c) has taken possession of the collateral.

Investment securities (Section 28(6)): a purchaser of a security... who,

(a) gives value;
(b) does not know that the transaction constitutes a breach of a security agreement granting a security interest in the security to a secured party that does not have control of the security; and
(c) obtains control of the security, acquires the security free from the security interest.

Uniform Commercial Code Article 9

Ordinary course of business (arts 9-320-321): the drafting here is somewhat different as the UCC talks of buyers in the ordinary course of business and contrasts that with consumer buyers.

Art 9-320(a) provides that a buyer in ordinary course of business takes free of a security interest created by the buyer's seller, even if the security interest is perfected and the buyer knows of its existence.

Art 9-320(b) provides that a buyer of consumer goods – from one who used them for domestic purposes – takes free of the security if he buys without knowledge of the security interest; for value; and before the filing of a financing statement covering the goods.

Article 9-321(c) provides for the corresponding rule re lessees in the ordinary course of business.

Chattel paper (article 9-330):

article 9-330(a): a purchaser of chattel paper has priority over a security interest in the chattel paper, claimed merely as proceeds of inventory subject to a security interest if, in good faith and in the ordinary course of the purchaser's business, the purchaser gives new value and takes possession of the chattel paper or obtains control of the chattel paper under Section 9-105; and the chattel paper does not indicate that it has been assigned to an identified assignee other than the purchaser.

Article 9-330(d) provides for the purchaser of an investment instrument to take free if he gives value (not new value) and has no knowledge the purchase violates the secured party's rights.

Negotiable instruments: negotiable instruments law takes priority under article 9-331(a), so holders take priority over earlier security to the extent provided by other articles of the UCC.

Law Commission

Because the final Law Commission proposals retain the distinction between fixed and floating charges – and the STR position is that the distinction be abolished – the proposals on taking free set out below are not directly transferable but they do reflect much of the policy thinking set out above.

"We recommend that a transferee (other than a secured party) of collateral that is subject to a registered… fixed charge should take subject to the charge unless the chargee has authorised the sale or other disposition." (Law Commission, *Company Security Interests* (Law Comm no 296 2005) para 3.218).

"We recommend that a transferee (other than a secured party) of collateral subject to a registered charge which is a floating charge, who acquired the collateral in a transaction which was in the ordinary course of the transferor's business, should take free of the charge unless the transferee knew that the sale was in breach of the terms of the charge." (Law Comm para 3.222).

Another significant difference lies in the fact that the Law Comm (para 3.224) simply saved the law regarding negotiable collateral – bills of exchange etc – and cash as does the UCC and OPPSA rather than as eg the APPSA 2009 does introduce rules to try to replicate the outcome (although it is not clear section 70 does so successfully).

Under the Consultative Report by contrast we find some similar proposals to those adopted in PPSA jurisdictions. Given the recommendation to abolish the fixed/floating distinction, the Law Comm (para 3.260) recommends that a purchaser for value from a seller in the ordinary course of business (or a lessor) take free unless he knows the sale or lease is in violation of the security agreement. Other exceptions relate (para 3.261) to low value domestic goods and (para 3.263) to serial numbered vehicles.

City of London Law Society

The CLLS Secured Transactions Code 2016 distinguishes between transactions with current assets and fixed assets and makes it more difficult to "take free" of security interests in fixed assets. This is used as a proxy for the distinction between transactions in the ordinary course of business and not.

Value is always needed; donees never take free under their scheme.

Appendix B

This appendix provides an overview of the different options for taking free rules where the security is unperfected or only temporarily perfected.

One related question is whether an unregistered (or unperfected) interest should be as in Australia/Canada void against liquidators or merely ranked in priority terms below perfected ones. This is treated in the registration policy paper.

Australia (Personal Property Securities Act 2009 (Cth))

Unregistered interests (Section 43): a buyer or lessee for value takes free of the security interest unless he was party to the transaction creating[16] it.

Temporarily perfected interests (Section 52): new value required and transferee disqualified if he has actual knowledge that it is a breach of the security interest.

New Zealand (Personal Property Securities Act 1999 (NZ))

Unregistered interests (section 52): identical to Australian provision.

Temporarily perfected interests (Section 56): new value required and transferee must be without "knowledge of the security interest."

In New Zealand therefore the temporary perfection rules are laxer and more advantageous to the security holder than in Australia.

Ontario (Personal Property Security Act 1990 (Ont))

Unperfected interests (Section 20):

Until perfection... (c) in chattel paper, documents of title, instruments or goods is not effective against a transferee thereof who takes under a transaction that does not secure payment or performance of an obligation and who gives value and receives delivery thereof without knowledge of the security interest;

(d) in intangibles other than accounts is not effective against a transferee thereof who takes under a transaction that does not secure payment or performance of an obligation and who gives value without knowledge of the security interest.

Uniform Commercial Code art 9

Unperfected interest (art 9-317(b)): a buyer... of tangible chattel paper, documents, goods, instruments, or a certificated security takes free of a security interest... if the buyer gives value and receives delivery of the collateral without knowledge of the security interest... before it is perfected.

16 Whittaker has now proposed that a purchaser for new value be disqualified if he has actual knowledge of the interest, which is a broader rule.

Para (c) provides the corresponding rule for lessees.

Para (e) provides an exception for pmsis that does not exist in other jurisdictions so if the pmsi is perfected within 20 days of the debtor receiving the goods it takes priority over an intervening buyer, lessee or lienee.

Law Commission

Purchaser of an asset subject to an unregistered charge takes free of the charge. Complete immunity they say encourages fraud so if the purchaser has actual knowledge of the existence of the fixed charge security (Law Commission *Company Security Interests* (Law Comm no 296 2005) para 3.214) he is bound by it.

The Commission had a different proposal regarding floating charges because of their different nature. In para 3.215 they argue that where the unregistered charge is a floating charge the buyer should not be bound by it even if they know of it, unless the disposition is not in the ordinary course of business or they know that it is in breach of the security agreement.

Another policy paper is being prepared on the effects of abolition of the distinction between the two types of charge.

In the Consultative Report (para 3.256) the Commission recommended that a buyer or lessee of collateral should take free of an unperfected SI unless it had knowledge of the existence of the security.

Appendix C

This appendix examines the relationship between retention of title financiers and invoice financiers.

Australia

Section 64 of the Personal Property Securities Act 2009 provides that a pmsi with super-priority will not take priority over a previously registered non-pmsi in accounts. A factor can also gain priority over the pmsi if his interest in accounts is later in time than the PMSI but he provides a statutory notice to the pmsi holder.

New Zealand

Section 75A of the Personal Property Securities Act 1999 provides: a non-proceeds security interest in accounts receivable that is given for new value has priority over a purchase money security interest in the accounts receivable as proceeds of inventory if a financing statement relating to the security interest in the accounts receivable is registered before the purchase money security interest is perfected or a financing statement relating to it is registered.

This was an amendment (Personal Property Securities Amendment Act 2004) to the original position which gave priority to the pmsi holder.

Ontario

Section 33(1) of the Personal Property Security Act 1990, provides for pmsi super-priority over prior registered security in accounts.

This is not a solution that will commend itself to invoice financiers, was abandoned in NZ and is not replicated elsewhere in Canada. See Section 34(6) of the Personal Property Security Act 1993 (Sask).

Law Commission

Because the Law Commission (*Company Security Interests* (Law Comm no 296 2005) para 1.14) does not recommend extending the scheme to retention of title and other title financing devices, the law regarding the relationship between those devices and assignments of receivables is left untouched.

Under the consultative report – para 3.223 – the Law Commission recommended that a secured party claiming an account as original collateral should have priority over a secured party claiming the account as the proceeds of a pmsi, provided that the receivables financier perfected its interest by filing before the pmsi secured party supplied the goods in question or filed in respect of its security interest. The Law Comm therefore adopts the more common approach and rejects the Ontarian system.

Appendix D

This appendix examines the registration prerequisites for super-priority; in some cases, the legislation requires the pmsi holder to provide notice to prior registered security holders that he intends to or will obtain a pmsi in specified assets.

Australia

Inventory

Section 62(2) of the Personal Property Securities Act 2009 (Cth) provides: the purchase money security interest has priority if it perfected by registration when the grantor… obtains possession of the inventory (if it is goods) or for any other kind of inventory the purchase money security interest attaches to the inventory and the registration that perfects the purchase money security interest states… that the interest is a purchase money security interest.

Personal property other than inventory:

Section 62(3) of the Personal Property Securities Act 2009 (Cth) provides: the purchase money security interest has priority if perfected by registration "before the end of 15 business days after whichever of the following days applies:

(a) for goods--the day the grantor… obtains possession of the property;
(b) for any other property--the day the interest attaches to the property; and
(c) the registration that perfects the purchase money security interest states… that the interest is a purchase money security interest."

This is subject to super-priority by control.

New Zealand

Inventory

Section 74 of the Personal Property Securities Act 1999 (NZ), provides: a purchase money security interest in inventory or its proceeds has priority over a non-purchase money security interest in the same collateral given by the same debtor if the purchase money security interest in the inventory or its proceeds is perfected at the time the debtor, or another person at the request of the debtor, obtains possession of the collateral.

Intangibles

Section 75 of the Personal Property Securities Act 1999 (NZ) provides: a purchase money security interest in an intangible or its proceeds has priority over a non-purchase money security interest in the same collateral given by the same debtor if the purchase money security interest in the intangible or its proceeds is perfected not later than 10 working days after the day on which the security interest in the intangible attached.

Everything else

Section 73(1)[17] of the Personal Property Securities Act 1999 (NZ) provides: a purchase money security interest in collateral or its proceeds, other than inventory or intangibles, has priority over a non-purchase money security interest in the same collateral given by the same debtor if the purchase money security interest in the collateral or its proceeds is perfected not later than 10 working days after the day on which the debtor, or another person at the request of the debtor, obtained possession of the collateral, whichever is earlier.

Ontario

Section 33(1) of the Personal Property Security Act 1990 (Ont)provides: a purchase-money security interest in inventory or its proceeds has priority over any other security interest in the same collateral given by the same debtor, if the purchase-money security interest was perfected at the time the debtor obtained possession of the inventory.

Before the debtor receives possession of the inventory, the purchase-money secured party must give notice in writing to every other secured party who has, before the date of registration by the purchase-money secured party, registered a financing statement that describes the collateral as

(i) items or types of inventory, all or some of which are the same as the items or types of inventory that will be subject to the purchase money security interest;
(ii) inventory;
(iii) accounts.

The notice must state that the person giving it has or expects to acquire a purchase-money security interest in inventory of the debtor.

If it is not inventory, Section 33(2) provides that a purchase-money security interest has priority over any other security interest in the same collateral given by the same debtor if the purchase-money security interest were perfected, in the case of collateral, other than an intangible within 15 days of

(i) the debtor obtained possession of the collateral as a debtor, or
(ii) a third party, at the request of the debtor, obtained or held possession of the collateral, whichever is earlier; or

In the case of an intangible it must be perfected before or within 15 days after the attachment of the purchase-money security interest in the intangible.

Uniform Commercial Code

Article 9-324(a) of the UCC provides that a purchase money security interest other than in livestock or inventory must be perfected within 20 days of the debtor taking possession. Under article 9-324(b) where the collateral is inventory perfection must take place before the

17 There is an exception under section 103A for security created by a participant in a settlement system in favour of the operator.

debtor takes possession and a notice must be sent to the conflicting security holder to be received no less than 5 years before the debtor takes possession.[18]

Article 9-324(d) provides for pmsis in livestock.

Software is dealt with separately under the UCC; remember that pmsis are not normally possible in intangible goods under the UCC, seemingly because of a lack of demand for such super-priority. However, the provision does need to deal with the problem of integrated software.

Article 9-324 (f) provides: "Except as otherwise provided in subsection (g), a perfected purchase-money security interest in software has priority over a conflicting security interest in the same collateral, and, except as otherwise provided in Section 9-327 a perfected security interest in its identifiable proceeds also has priority, to the extent that the purchase-money security interest in the goods in which the software was acquired for use has priority in the goods and proceeds of the goods under this section."

This is subject to super-priority by control of deposit account under Article 9-327.

Law Commission

Although in the final report the re-characterisation of retention of title clauses was dropped, originally para 3.219 of the Consultative Report stated, "We provisionally recommend that a PMSI over goods that are not inventory should have priority over any other conflicting SI provided that it is perfected not later than 10 days after the debtor obtains possession of the collateral. In the case of a PMSI over intangibles, the 10 day period should date from attachment."

Where it was inventory a notice was also required. By para 3.214 the Law Comm argued, "We provisionally recommend that for an SI over inventory to have PMSI status, it must be perfected, and a notice must have been given to any other secured party who has filed a financing statement covering the same type of collateral, before the debtor (or another person on its behalf, if earlier) obtains possession of the collateral. The notice must state that the person giving the notice expects to acquire an SI in inventory, and describe the inventory by item or kind."

18 Lack of time limit for the notice in Ontario.