

# **A Hoary Chestnut Resurrected: the Meaning of “ordinary course of business” in Secured Transactions Law<sup>1</sup>**

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## **1. Introduction**

It is common for a debtor to sell goods that the debtor has previously given as collateral. Often, this will be in conformity with the mutual intention of the debtor and the secured creditor. This would be the case, for example, where the creditor is secured over inventory that both parties expect the debtor to sell at a proper price in the course of the debtor’s business. With inventory financing, the secured creditor will commonly expect much of the sale proceeds to be applied towards repaying the secured creditor but, if the debtor is financially distressed or dishonest, this expectation may not be met. If the inventory financier goes unpaid, there will be times when the creditor will look to recover the inventory, even where it has been on-sold.

In addition to the sale of inventory, there may be other times when the secured creditor expects, or at least accepts, that the debtor will dispose of collateral. This may be the case, for example, where the debtor regularly acquires new equipment and disposes of obsolete equipment. Conversely, there may be occasions when a secured creditor objects even to the sale of inventory; such as where inventory is sold in suspect circumstances to a party related to the debtor or is otherwise sold on terms unacceptable to the secured creditor.

Whenever the secured creditor disapproves of the sale of collateral, whether inventory, equipment or some other asset type, the scene is set for a conflict between the secured creditor and the buyer. Provisions of the Personal Property Securities Acts of Australia (“Aus”) and New Zealand (“NZ”) comprehensively deal with such conflicts and determine which of the secured party and buyer prevails.<sup>2</sup> This paper addresses one such provision: s 46 Aus and s 53 NZ - sales in the ordinary course of business. If the Australian experience mirrors that of New Zealand, it will be some time before there is any significant litigation over the meaning of ordinary course of business in this context. Initially, PPS litigation in New Zealand focused on conceptual aspects arising under the Act, before the natural progression to a consideration of more operational issues. But in due course, there will be litigation in Australia, as there has been in New Zealand, over the meaning of the ordinary course of business because the concept is as significant in the context of the Personal Property Securities Acts of both countries as it was in the past in relation to Australasian voidable transactions law.

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<sup>1</sup> This paper is still in draft and should not be cited. A refined version should be published later this year.

<sup>2</sup> For ease of reading, section references to the Personal Property Securities Act 2009 (Cth) and the Personal Property Securities Act 1999 (NZ) will refer simply to Aus and NZ respectively. References to “the Act” will refer to personal property securities legislation of Australia, New Zealand or Canada as the context requires.

It is worth noting, though, that secured creditors will not challenge the vast majority of sales that occur daily. Most everyday sales will be in the ordinary course of business and this will be obvious. Section 46 (Aus) and s 53 (NZ) are essentially straight forward sections that will quietly operate as intended and almost unnoticed. It will only be necessary to examine the finer nuances of the sections where the secured creditor has concerns over the propriety of a sale, either because it involved property that the debtor did not usually hold for resale or because the secured creditor had reason to be alarmed about the terms of the sale or the parties to it.

## 2. A Starting Point

When faced with the competing claims of a secured creditor and a buyer to whom the debtor has sold the secured creditor's collateral, it is sensible and logical to begin with the assumption that the security interest is effective against both the debtor and the buyer and then to ask whether there is any applicable exception to this starting point. Statutory recognition of this starting point is found in s 18 Aus and s 35 NZ. These provisions confirm that a security interest is effective according to its terms. The NZ provision expressly provides that this potentially powerful proposition is subject to the other provisions of the Act. The Australian provision does not state this expressly, but it is necessarily so. These "effectiveness provisions" are reinforced by s 32 Aus and s 45 NZ, which provide, amongst other things, that a security interest continues in collateral sold by the debtor.

The most obvious provisions of the Acts that must override the effectiveness provisions, where there is any conflict between the terms of a security agreement and the rights of third parties, are the provisions requiring certain formalities to be satisfied before a security interest is enforceable against third parties, the provisions determining the respective priorities of competing security interests and the provisions giving buyers clear title despite the existence of a security interest over the purchased property.<sup>3</sup>

By starting with the presumption that a security agreement is effective against third parties (provided the formalities required by the Act have been complied with<sup>4</sup>), it is clear that a secured party will prevail over a buyer unless the buyer comes squarely within one of the buyer protection provisions. In *Associates Commercial Corp of Canada v Dependable Transportation Inc* the matter was put this way:<sup>5</sup>

The law is clear that the onus is on the [buyer] to establish beyond the balance of probability that it falls within the scope of [a buyer protection provision].

The various buyer protection provisions can overlap but it is necessary only that a buyer comes within any one or more of these provisions to prevail against a secured creditor. Essentially,

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<sup>3</sup> The effectiveness provisions of both Aus and NZ are also stated to be subject to other laws. This is provided within the NZ effectiveness provision s 35 NZ but in Aus it is located separately in s 257. Although this allows the general law to continue to apply in areas the Act does not cover, such as contractual capacity, illegality, fraud and duress, the general law should not be applied in a manner inconsistent with the scheme of the legislation.

<sup>4</sup> For non possessory security interests, this commonly requires a written security agreement signed or acknowledged by the debtor: s 20 Aus and s 36 NZ.

<sup>5</sup> (1994) 8 PPSAC (2d) 172 at para 11.

provided a buyer satisfies the requirements of the relevant provision, the interest acquired by a buyer will prevail over a security interest:

- Where the security interest is unperfected at the time the buyer becomes a buyer: s 43 Aus, s 52 NZ;
- Where the security interest is temporarily perfected: s 52 Aus, s 56 NZ;
- Where the regulations require the secured party to register serial numbers for the collateral and the secured party has failed to do so correctly: ss 44 and 45 Aus, s 55 NZ;
- In the case of motor vehicles, where the seller is a dealer and the buyer is not: s 45(3) and (4) Aus, s 58 NZ;
- Where the buyer is buying low value consumer goods for personal use: s 47 Aus, s 54 NZ; and
- The subject of this paper, where the buyer buys in the ordinary course of business of the seller: s 46 Aus, s 53 NZ.

In each of the above cases, lessees are protected as well as buyers but for ease of reference, this paper will refer only to buyers. Further sections (not dealt with in this paper) protect persons, who could include buyers, acquiring interests in investments such as shares (for example, ss 49, 50 and 51 Aus, s 97 NZ) and other negotiable and quasi negotiable collateral (such as money and chattel paper).

If none of these provisions exactly cover a buyer's circumstances, a secured party whose security interest has attached to the property bought will prevail against the buyer. The effectiveness provisions can be taken as confirmation of this.

### **3. Defining Buyers**

“Buyer” is not defined in the Acts. However, it is clear that the term should be given its common meaning, which is deliberately different to that of the defined term “purchaser”. Put simply, a purchaser is someone who acquires a proprietary interest under any form of consensual transaction.<sup>6</sup> On the other hand, a buyer should be limited to someone who acquires property under a contract of sale and is thus a narrower term than purchaser. The term “purchaser” would include a buyer but would also cover, for example, a secured creditor and, at least in New Zealand, a donee of a gift.

Some transactions structured as sale and purchase agreements may in fact be disguised financing arrangements. For example, this could be the case where an agreement for the sale of goods that contained put and take options would likely result in the goods later being reacquired by the original seller at a price calculated to provide the original buyer with a predetermined return on the original purchase price. Where any such transactions come within the statutory definition of security interest, they should be characterised as such and not as sale transactions. The original

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<sup>6</sup> See, for example, s 50 Aus and s 16 (definition of purchase and purchaser) NZ.

“buyer” would then not be a buyer for the purpose of the buyer protection rules and instead would be classified as a secured party for the purposes of the priority provisions of the Act.<sup>7</sup>

The argument that a transaction that had been documented as a sale was in fact a disguised security interest, and should have been regulated as such, was made and rejected in the *Tubbs v Ruby* litigation.<sup>8</sup> The core facts were largely undisputed. The debtor company, Waimate, had given an all assets security to the ANZ bank. Waimate experienced financial difficulties and its directors established a new company, Ruby, to “buy” inventory from Waimate for the purpose of “assisting Waimate with its cash flow problems.”<sup>9</sup> Ruby paid full price but the inventory never left Waimate’s possession and Waimate continued to deal with the inventory, either by swapping it for other inventory on hand whenever Waimate needed to use the inventory “sold” to Ruby or by on-selling the inventory to Waimate’s customers on Ruby’s behalf. Ruby had no premises, no staff and no customers of its own. Ruby’s only means of realising on the inventory that it “bought” was through Waimate. As Waimate’s financial position presumably deteriorated further, eventually, and allegedly improperly, Waimate started selling the Ruby inventory without either swapping it for equivalent inventory or accounting to Ruby for the on-sale proceeds and the arrangement started to unravel. The ANZ Bank appointed receivers to Waimate and the receivers applied for an injunction preventing Ruby from dissipating the proceeds of the Ruby inventory.

In the Court of Appeal, Counsel for the receivers argued that the arrangement between Waimate and Ruby gave rise to a security interest as defined by the PPSA. To be a security interest, Ruby’s “buyer” interest in the inventory would need to have secured performance of some obligation owed by Waimate but the Court held as a matter of fact that Waimate owed no such obligation. Had this finding followed a full hearing, it may well have been justified but, in the author’s respectful submission, it was inappropriate for the interlocutory application before the Court. To succeed on the interim application for an injunction, all the receivers had to show was that it was seriously arguable that Waimate owed an obligation to Ruby. Ruby’s only practicable means of realising the inventory acquired from Waimate was either to sell the inventory back to Waimate, to enter into a swap arrangement with Waimate or to sell it to Waimate’s customers by effectively diverting orders received by Waimate to Ruby. This had been the invariable practice during the relationship, which may well be indicative of an obligation and so should have satisfied the serious question standard. The Court of Appeal itself said that the High Court had analysed the relationship between Waimate and Ruby as “arguable,”<sup>10</sup> indicating there was no conclusive analysis of the terms of the arrangement, and had Counsel for the receivers been given the opportunity to cross examine Ruby’s deponents it may well have been possible to tease out the details that would have elevated an invariable practice into an obligation.

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<sup>7</sup> The Australian Act expressly mandates this outcome (s 42(b)) but it is equally clear that, by applying a purposive interpretation to the Act, the same analysis applies in New Zealand even though the New Zealand Act is silent on the point.

<sup>8</sup> *Tubbs v Ruby 2005 Ltd* [2010] NZCCLR 31 (interim injunction application); [2010] NZCA 353 (interim injunction appeal) and [2011] 3 NZLR 551 (substantive hearing).

<sup>9</sup> [2010] NZCCLR 31 at para 12.

<sup>10</sup> See the Court of Appeal judgment at para 7.

#### **4. The Role of Ordinary Course Transactions**

If you buy an appliance from Harvey Norman you do not expect to run the risk that Harvey Norman's secured creditors may be entitled to take the appliance from you. Buyers, whether domestic or commercial, reasonably expect that when they buy goods on usual terms from a dealer in such goods, they will acquire the goods free of any security interests given by the dealer. Secured credit is supposed to facilitate commerce, not hinder it, and it would be inappropriate if buyers in a market commonly needed to check whether the goods being acquired were subject to a prior security interest and, if they were, to obtain a discharge of the security interest. Before the enactment of the PPS Acts, floating charge jurisprudence, supported by other law, allowed goods that were subject to a floating charge, as inventory commonly was, to be sold to buyers free of the charge. If a secured creditor did not want the debtor to be able to sell the collateral free of the secured creditor's security interest, it was generally necessary to take a fixed charge over the collateral, as was commonly done with plant and machinery. PPS legislation has made the floating charge largely irrelevant, and done away with the distinction between fixed and floating charges, but still allows secured creditors to take security over assets that the secured creditor expects the debtor to sell. Buyers from dealers still expect to acquire clear title to the goods they buy and so it is necessary to replace the old floating charge jurisprudence with statutory provisions designed to achieve commercially acceptable results. The ordinary course of business provisions, s 46 Aus and s 53 NZ, are a key part of the statutory structure that supersedes the old floating charge law. Often, these will be the only provisions that allow a buyer to resist a secured party's claim for the return of goods sold to the buyer by the debtor and so will be a central feature of the functioning of the PPS regime.

#### **5. The Buyer's Seller Rule**

The ordinary course of business provisions only protect a buyer in the ordinary course of business from security interests given by the buyer's seller. That is, if a security interest has been given by someone other than the person from whom the buyer acquired the property, such as an earlier owner, the buyer is not directly protected by the ordinary course provisions.<sup>11</sup> For example, if a consumer has given a security interest over his or her boat, and subsequently sells it to a boat dealer without paying off the secured creditor and in circumstances where the security interest is not cut off by that transaction, a later buyer in the ordinary course of business from the boat dealer will not be protected by the ordinary course provisions because it was not the boat dealer that created the security interest. Various commentators, and even some courts, have suggested that this is an anomaly or lacuna in the section, but it is a long established and deliberate rule. While there is scope to debate the policy behind the rule, it can be viewed simply as a deliberate drawing of the line in favour of the secured creditor in that circumstance. One of two innocent parties (ie, the secured party whose collateral has been improperly disposed of by the debtor and the end buyer) must lose and here the legislature has determined that the secured party should prevail.

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<sup>11</sup> The buyer will of course be protected if the ordinary course rule has previously operated in favour of an earlier buyer. Once a buyer protection rule has operated to protect a buyer from a security interest, the security interest will be cut off so that any subsequent buyers are also protected. This is sometimes known as the doctrine of sheltering because the subsequent buyer is sheltered by the earlier buyer's clear title.

## 6. Australasian Drafting Differences in the Ordinary Course Provisions

Section 46 Aus and s 53 NZ clearly share the same pedigree but there are some potentially significant differences.

The New Zealand provision only applies to goods. The Australian provision is not so limited and potentially could protect buyers of other types of personal property. It is difficult to assess the importance in practice of this difference but its relevance is somewhat lessened by s 49 Aus which further protects buyers of investment instruments and intermediated securities in the ordinary course of trading on a prescribed financial market (within the meaning of the Corporation s Act 2001) so that such buyers would not need to rely on s 46. Nevertheless, it seems s 46 could potentially apply to the sale of investment instruments not traded on a prescribed financial market and to other intangible property such as intellectual property rights.

On the other hand, the class of buyer within the ambit of s 46 Aus is more limited than under s 53 NZ. Section 46(2) Aus excludes from the protection of the section persons who are buying serial number property as inventory.<sup>12</sup> This subsection did not appear in the 2008 draft bill but had been inserted by the time the bill was introduced in 2009. The author has not been able to locate any official commentary on the rationale for this amendment,<sup>13</sup> but it has been suggested elsewhere (in relation to this and the other buyer protection provisions containing a similar limitation) that:<sup>14</sup>

The drafters of the PPSA may have taken the view that a person who buys or leases property as inventory is likely to be a large and sophisticated institution that is able to identify and deal with existing security interests without needing to rely on the extinguishment rules. In practice, however, the non availability of these extinguishment rules may be a significant impediment even for large and sophisticated institutions, as it could greatly complicate the processes by which buyers and lessees acquire their inventory, resulting in longer transaction times and greater transaction cost. This situation is exacerbated even further by the fact that the term “inventory” has a very broad meaning, as this in turn broadens the range of circumstances in which these extinguishment rules will not be available.

In addition to the points raised in the above quote, it may be added, in relation to ordinary course sales of inventory, that excluding from the ambit of the section any particular persons may generally be of little moment. Even if excluded buyers do not take the alternative steps to protect themselves that seem to be intended by the provision, they will in any event often be able to rely on the general law principle that an inventory financier usually expects the debtor to sell the collateral and therefore the financier can be taken to have impliedly authorised the sale so that the buyer will take free of the security interest under s 32(1)(a)(i) Aus and s 45(1)(a) NZ.<sup>15</sup> Excluding certain inventory buyers from s 46 Aus simply gives s 32 Aus greater relevance in this context than it should be given.<sup>16</sup>

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<sup>12</sup> In Australia, serial number property is presently aircraft, motor vehicles and watercraft and certain types of intellectual property: see Personal Property Securities Regulations sched 1 cl 2.2 (Aus).

<sup>13</sup> It is noted but not explained at paragraph 2.89 of the Explanatory Memorandum.

<sup>14</sup> Bruce Whittaker in *Personal Property Securities in Australia*, LexisNexis, Australia, 2010 at 4.1.4700.

<sup>15</sup> These provisions are discussed further in para 11 below.

<sup>16</sup> The interplay between ss 32 and 46 Aus (ss 45 and 53 NZ) is also discussed further in para 11 below.

But the most intriguing potential difference between the Australian and New Zealand ordinary course provisions is in the types of transaction to which the provisions apply. The concept of “ordinary course of business” transactions was relevant for a long time under the Australasian law relating to voidable transactions in corporate insolvency but it was eventually dropped in that context because of ongoing uncertainty over its meaning and application.<sup>17</sup> In respect of voidable transactions, it was accepted that in the main the notion of the ordinary course of business referred to the manner in which business was conducted generally, rather than the manner in which any particular business was carried on. Thus it was said in one case:<sup>18</sup>

[T]he phrase ‘ordinary course of business’ impute[s] an objective view of the course of business rather than a subjective one such as the way in which particular parties carry on their business.

Similarly, it was suggested in that context that the phrase referred to business as a general conception rather than to the conduct of any particular industry,<sup>19</sup> but despite such dicta, it was wrong to ignore entirely industry customs and individual practices. As one Judge noted:<sup>20</sup>

It would be unrealistic to suggest that there is a single course of business within the commercial community against which the conduct of each and every business, and each and every business transaction, can be objectively measured.

One case attempted to reconcile this apparent tension between an objective and a subjective analysis of the ordinary course of business in the following fashion:<sup>21</sup>

- the principle criterion is practice in the commercial world in general;
- nevertheless, the company’s own past practices and dealings with the creditor are relevant; and
- the transaction should generally fall within the ordinary operational activities of a business as a going concern and not be a response to abnormal financial difficulties or consequent on winding down the business.

It was perhaps partly in response to the obvious difficulties the Courts had historically faced in determining the ordinary course of business, and the baggage that came with the phrase in the context of voidable transactions law, that the drafters of the Australian Act attempted to give further guidance on the scope of the phrase for the purposes of the Personal Property Securities Act. It had already been clarified by the uniform Canadian legislation (ie, the provincial Canadian Personal Property Security Acts other than the Ontario Act) and the New Zealand Act that in those jurisdictions the test did refer to the ordinary course of business of the particular debtor, rather than of the commercial world in general, and the Australian Act has also adopted this approach. Thus s 46 Aus and s 53 NZ both refer to the “ordinary course of business *of the seller*.” But the Australian Act has gone further and provides that the section only applies to sales in the ordinary course of the seller’s *business of selling personal property of that kind*. Case law has established that while the New Zealand and uniform Canadian provisions will often apply to the sale of inventory, they are not limited just to the sale of inventory.<sup>22</sup> This may not

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<sup>17</sup> The ordinary course of business defence to the recovery of preferential payments remains relevant to Australian personal insolvency law under s 122 of the Bankruptcy Act 1966 (Cth).

<sup>18</sup> *James Hardie Building Products Ltd v Meltzer* [1996] 2 NZLR 506 at 510 per Barker J.

<sup>19</sup> See, for example, *Re K & Receiver Fabrications (Qld) Pty Ltd (in liq)* (1980) 32 ALR 183.

<sup>20</sup> Potter J in *Re Inspiration Homes Ltd (in liq)* (1997) 8 NZCLC 261,413 at 261,417.

<sup>21</sup> *Re Modern Terrazzo Ltd (in liq)* [1998] 1 NZLR 160 at xxx.

<sup>22</sup> *Camco Inc v Frances Olsen Realty (1979) Ltd* [1986] 6 WWR 258 at 272.

be the position in Australia. On one interpretation, the effect of the additional words in the Australian Act may be either or both of the following:

- to limit the application of s 46 to inventory of the debtor;
- and even then, only to inventory held for sale.

If this is so, sales of, say, obsolete or surplus equipment would never be covered by s 46 Aus, even where commonly transacted by a debtor, and sales of inventory held for lease rather than sale would also be excluded.<sup>23</sup> This is one possible interpretation of the closing words of s 46(1) Aus and appears to be consistent with the explanatory memorandum. The explanatory memorandum does not expressly state that s 46 Aus is intended to apply only to inventory held for resale but the first of the two hypothetical examples given suggests this. The examples given appear to be based on two Canadian cases, with the first example departing from the Canadian law and the second one following what the Australian drafter apparently assumed to be the Canadian position.

The first example given at paragraph 2.90 of the explanatory memorandum is that of a debtor primarily in the business of leasing, repairing and rebuilding cranes but whose practice was to sell a crane once it became obsolete or difficult to lease. This hypothetical example mirrors the facts of *Alberta Pacific Leasing Inc v Petro Equipment Sales*. In *Alberta Pacific* the sale of a crane in these circumstances was held to be in the ordinary course of business even though there were only one or two sales made by the debtor that year. Under the Alberta equivalent of s 46 Aus and s 53 NZ, the buyer, Petro Equipment, accordingly took the crane free of Alberta Pacific's perfected security interest. But the hypothetical example in the Australian explanatory memorandum provides otherwise. Although the example acknowledges that the sale would be in the ordinary course of the debtor's business, it goes on to say that the sale would not be in the ordinary course of the debtor's "business of dealing with property of that kind," paraphrasing the concluding words of s 46(1) Aus. Because of the broad definition of inventory, the cranes held for lease would be inventory of the debtor but because the debtor was primarily in the business of leasing and not selling, the example in the explanatory memorandum states that s 46 would not apply.

If, however, one ignores the first example given in the explanatory memorandum, it is plausible to argue that the additional words of s 46 Aus do not require a different interpretation to the New Zealand or Uniform Canadian Acts. In the Canadian case of *Camco Inc v Frances Olson Realty (1979) Ltd* it was held that when interpreting the wording of s 30(1) of the Saskatchewan PPSA, which refers only to the ordinary course of business of the seller (without expressly stating that the business must be selling goods of that kind):<sup>24</sup>

[T]he trier of fact should consider whether the person was a person in the business of selling goods *of that kind* and whether the transaction took place in the ordinary course of that business [emphasis added].

Although even absent the Australian statutory direction, *Camco* holds that the seller's business must be selling goods "of that kind," the case also states that this is not limited to inventory held

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<sup>23</sup> As noted above, inventory is broadly defined and includes property held for leasing out.

<sup>24</sup> [1986] 6 WWR 258 at 276.

for resale.<sup>25</sup> While the author has been unable to determine the origin of the Australian wording, it is possible that it was derived from *Camco*; in which case, despite the example given in the explanatory memorandum, there may be no significant difference between the Australian and New Zealand formulations of the ordinary course test.

On the other hand, given the example in the explanatory memorandum, it seems more likely that the Australian wording was derived directly from Article 1-201 of the American Uniform Commercial Code. Article 1-201 defines ordinary course buyers for the purpose of Article 9, from which ultimately the PPSAs are derived. Like s 46 Aus, Art 1-201 requires the seller to be “in the business of selling goods of that kind.” The official comment to Article 9-320 (the equivalent of s 46 Aus and s 53 NZ) states that the section “applies primarily to inventory collateral,” implying that it will occasionally apply to non-inventory items. On the face of it, this is arguably little different to the Canadian or New Zealand position but case law suggests otherwise. US cases have generally found that the sale of obsolete equipment or rental inventory is not in the ordinary course of business of selling goods of that kind.<sup>26</sup>

Having regard to the US position, and (given the example in the explanatory memorandum) the possibility that the Australian legislation was modelled on the US test, the conservative view is that the ordinary course test in Australia is essentially limited to the sale of inventory held for resale and is accordingly more restrictive than the applicable test in New Zealand and Canada. Nevertheless, this possible narrowing of the meaning of ordinary course of business should not make much difference in commercial practice. In New Zealand, prudence already dictates that an intending buyer of goods that are not primarily held for sale by the seller should obtain the agreement of any secured creditors to the sale to ensure clear title. The Australian wording simply makes this practice even more desirable.

The second example given in paragraph 2.90 of the Australian explanatory memorandum mirrors the facts of *Saskatchewan Wheat Pool v Smith*<sup>27</sup> and states that the regular exchange of cattle for cattle food by a cattle farmer whose primary business was *dealing* in cattle would nevertheless be sales in the ordinary course of business. One could point out that the exchange of cattle for cattle food would still be a *dealing* with the cattle but presumably the example refers to modes of dealing and was intended to contrast the primary business of selling on a recognised market with other modes of disposal. The *Saskatchewan Wheat Pool* decision is widely considered to have held that in these circumstances the particular exchange of cattle for cattle food was in the farmer’s ordinary course of business, probably based on the head note which says this, but in fact nowhere in the judgment is this made clear and ultimately the buyer lost out to the secured creditors because the purchase price for the cattle was set off against a pre-existing liability.<sup>28</sup>

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<sup>25</sup> Ibid at 272.

<sup>26</sup> See *Wells Fargo Bank Northwest v RPK Capital XVI LLC* [2010] TX App Ct Briefs 565 and the cases cited therein. One case even held that the sale of ex rental cars by a rental car company that sold 4000 cars a year, generating more than 60% of its gross revenue, was not in the business of selling cars: *Union Planters Bank NA v Peninsula Bank* (2005) 897 So 2d 499.

<sup>27</sup> (1996) 11 PPSAC (2d) 209, affirmed (1997) 152 Sask R 79 (Sask CA)

<sup>28</sup> The case did state, obiter, that private sales between farmers were in the ordinary course of their businesses, even though the primary method of sale was at public market, because the private sales were routine and a normal and an ongoing aspect of the farmers’ businesses. But in the end, the Court seems to have held that the particular transaction in issue was not even prima facie a sale because the cattle were simply delivered to satisfy a past liability

While the Australian example indicates that a secondary mode of selling inventory, where the bulk of sales are conducted in some other way, can still be in the ordinary course of business if the secondary mode is regularly engaged in, it should not be taken as suggesting that property transferred in settlement of an existing debt will necessarily constitute a sale in the ordinary course of business.

Although the second Australian explanatory example does not necessitate any difference in approach between Australia and New Zealand, care should be taken not to emphasise unduly the example's reference to the debtor's *primary* business. There should be no implication taken that only sales in the course of the debtor's primary business can be ordinary. Again, the analysis in the leading Canadian decision of *Camco Inc v Frances Olson Realty (1979) Ltd*<sup>29</sup> should apply with equal force in Australia (as it does in New Zealand). In *Camco*, the seller was a property developer who developed and sold residential apartments. The purchase price for the apartments included an appliance package. At issue was whether the appliances were sold in the ordinary course of business of the property developer for the purposes of the Personal Property Security Act (Sask). The Saskatchewan Court of Appeal noted that:<sup>30</sup>

The mere fact that the seller was engaged in the selling of appliances as an incident to his primary business of selling condominium units does not preclude the operation of [the ordinary course provision].

There is no requirement that sales be part of the primary line of business of the seller; merely that they are in the ordinary course of that business, or, in Australia, in the ordinary course of the business of selling that kind of property.

*Camco* also usefully confirms that the relevant test is the particular seller's way of doing business, not that of the particular industry or commerce generally. The Court of Appeal approved of the trial judge's view that although property developers may not ordinarily equip units with appliances, the relevant section "is not concerned with the ordinary course of developers generally but with the ordinary course of business of [the particular developer]."<sup>31</sup>

## 7. General Principles

Because the test requires that the seller be in business, the section will not apply to private sales.<sup>32</sup> For simplicity of analysis, this leads to a two stage test that can broadly be stated as: first, what is the nature of the seller's business and secondly, was the sale in issue in the ordinary course of that business.<sup>33</sup> A sale of an item of inventory held for resale for a fair price to a customer of the debtor of the usual type and on normal terms will be the most common example of a sale in the ordinary course of business. Section 46 (Aus) and S 53 (NZ) will operate as intended to give the buyer title clear of any security interests given by the seller and the seller's

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(see para 41 of the judgment). This res judicata is of limited relevance in Australasia because the Saskatchewan Act, unlike those of Australia and New Zealand, expressly provides that a transfer in total or partial satisfaction of an existing debt is not a sale in the ordinary course: see s 30(8) Sask PPSA.

<sup>29</sup> [1986] 6 WWR 258.

<sup>30</sup> Ibid at 277.

<sup>31</sup> Ibid at 269.

<sup>32</sup> See, eg, *Royal Bank of Canada v 216200 Alberta Ltd* (1986) 33 DLR (4<sup>th</sup>) 80.

<sup>33</sup> This two stage approach was adopted in *Orix New Zealand Ltd v Milne* [2007] 3 NZLR 637 at para 66. See also the test set out in para 6 above taken from *Camco Inc v Frances Olson Realty (1979) Ltd* [1986] 6 WWR 258 at 276.

secured creditors would not expect otherwise. But in other cases, a closer examination of the meaning of the ordinary course of business will be required.

Although the ordinary course of business test is utilised in many statutory and common law contexts across Australasia, there is limited utility in examining the meaning ascribed in these different settings. This caution has previously been voiced in the context of voidable transactions law, in reference to which Fisher J stated:<sup>34</sup>

I cannot help wondering whether some of the difficulties in this area may be due to the attempt to transplant ordinary course of business tests drawn from other contexts where the phrase has had to serve a very different function or, even more dubiously, where the words themselves were different.

In particular, the meaning of the phrase for the purposes of voidable transactions law (the very context with which Fisher J was concerned) and floating charge law, should be treated with caution when applied to PPS legislation. Analyses in the context of voidable transactions law are of limited value because there the phrase essentially refers to the way commerce is conducted generally, rather than the particular seller's modus operandi, and because the policy underpinning voidable transactions law, which serves to uphold the pari passu principle of insolvency law by setting aside certain pre-insolvency transactions, favours a stricter interpretation of the phrase than is called for in the context of secured transactions law where the phrase serves a consumer protection function. Prior analysis of the phrase in the context of floating charge jurisprudence is also of limited value, both because the "ordinary course of business" was never the universally accepted test in that context,<sup>35</sup> and because the PPSA security interest covers both circulating and non circulating assets, whereas the floating charge generally applied only to circulating assets.

This is not to say that prior Australasian precedents should be ignored entirely. For example, the traditional suspicion with which Australasian courts have regarded transactions with associated persons remains relevant in the context of the PPSAs<sup>36</sup> and generic formulations of ordinariness can also inform the concept for the purposes of the PPSAs.<sup>37</sup> But primarily, the Australasian courts should look for guidance to North American precedents where the phrase has been used in the context of PPS legislation. A comment made elsewhere by the author to this effect was approved in the case of *Orix New Zealand Ltd v Milne*.<sup>38</sup>

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<sup>34</sup> *Re Modern Terrazzo Ltd (in liq)* [1998]1 NZLR 160 at 177.

<sup>35</sup> While some floating charge cases held that the grantor of a floating charge could only dispose of assets free of the floating charge in the ordinary course of business (implying a qualitative limitation), others referred simply to the course of business (implying only a temporal limitation so that virtually any dealing was authorised while the business continued to trade). For example, Glass JA in *Reynolds Bros (Motors) Pty Ltd v Esanda Ltd* opined that "the only question for consideration is whether the transaction was undertaken by [the grantor of the charge] in the course of maintaining its business as a going concern." (1983) 8 ACLR 422 at 424. See also *In re Old Bushmills Distillery Co* [1987] 1 IR 488 where a sale by a financially distressed company of a large quantity of its inventory to a syndicate of its creditors was held to be in the course of its business, and hence passed free of the charge; an outcome that almost certainly would not follow under the PPSAs.

<sup>36</sup> For example, see *Torzillu Pty Ltd v Brynac Pty Ltd* (1983) 8 ACLR 52 at 60.

<sup>37</sup> Indeed, one Canadian case considering the concept for the purpose of PPS legislation referred to a New Zealand decision that discussed the phrase in the context of voidable transactions law; see *369413 Alberta Ltd. v. Pocklington* [2001] 4 WWR 423, applying the New Zealand Privy Council decision in *Countrywide Banking Corp. v. Dean* [1998] AC 338.

<sup>38</sup> [2007] 3 NZLR 637 at para 62.

Because it is necessary to consider the circumstances of each case, it is neither possible nor wise to formulate a universally applicable definition of ordinary course of business for the purposes of s 46 Aus and s 53 NZ.<sup>39</sup> This is so even in Ontario, where the different statutory formulation means that the test is the less subjective ordinary course of commercial practice generally, rather than the more subjective particular seller's ordinary course of business that applies in Australasia. In the leading Ontario decision of *Fairline Boats Ltd v Leger*<sup>40</sup> the Court suggested:

in deciding whether a transaction is in the ordinary course of business, the courts must consider all of the circumstances of the sale. Whether it was a sale in the ordinary course of business is a question of fact.

But while the particular facts might be said to determine the answer, such a question will never be purely a question of fact. It will be a mixed question of fact and law and it is possible to state some broad general legal principles that will help to answer the question.

Generic business ordinariness has often been expressed broadly, both in non-PPS and PPS contexts as “part of the undistinguished common flow of business carried on, calling for no remark and arising out of no special or peculiar situation.”<sup>41</sup> Provided the caveat concerning the danger of adopting such a test from a non-PPS context is kept in mind, such a formulation can be helpful in setting the parameters for the factual inquiry required. One can then apply the various factors more directly relevant to determining whether a particular sale is in the ordinary course of a particular seller's business. *Fairline Boats* listed the following as specific examples of relevant, though not definitive, factors in the context of sales under PPS legislation:<sup>42</sup>

- Where the agreement is made. Sales made at the seller's premises are more likely to be ordinary course than sales made away from the seller's premises;
- A sale to an everyday consumer buyer is more likely to be ordinary course than a sale to a dealer or financial institution. However, dealers must buy their inventory from somewhere and the Court did go on to say that in proper circumstances, a dealer would be protected by the ordinary course provision. Also, the statement that sales to consumers are more likely to be ordinary course was made in the context of a retailer's sales; it would not apply to sales at other levels in the supply chain such as those by a manufacturer or wholesaler;
- The quantity of goods sold. A sale of one or a few items is more likely to be ordinary course than a bulk sale of a large proportion of the seller's inventory. Again, this comment was made in the context of a retailer's sales and is more likely to be relevant in that environment;

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<sup>39</sup> See, eg, *Camco Inc v Frances Olson Realty (1979) Ltd*, *ibid* at 276 where the Court opined: “Since the question of whether a buyer is a buyer under [s 46 Aus, s 53 NZ] is a question of fact, I would not attempt to articulate an all inclusive definition . . . .”

<sup>40</sup> (1980) 1 PPSAC 218 at 222.

<sup>41</sup> For example, *Downs Distributing Co Pty Ltd v Associated Blue Star Stores Pty Ltd (in liq)* (1948) 76 CLR 463 at 477 (voidable transactions context); *Julius Harper Ltd v F W Hagedorn & Sons Ltd* [1991] 1 NZLR 530 at 543 (floating charge context); *Aubrett Holdings Ltd. v. R.*[1998] GSTC 17 (PPS context); *369413 Alberta Ltd. v. Pocklington* [2001] 4 WWR 423 (PPS context).

<sup>42</sup> (1980) 1 PPSAC 218 at 222 and 223. The Court in *Tubbs v Ruby 2005 Ltd* [2010] NZCCLR 31, while purporting to adopt the *Fairline* formulation, in fact adopted the expanded list of factors from *Alberta Pacific Leasing Inc v Petro Equipment Sales Ltd*, *infra*.

- The sale price. A sale at or near market price is more likely to be ordinary course than a sale well below market price;

But “[t]his list is not intended to be exhaustive and other criteria may also be useful.”<sup>43</sup> Also, although *Fairline Boats* and other Ontario decisions have provided helpful guidance in defining the ordinary course of business, when looking at Ontario case law it must always be remembered that:<sup>44</sup>

[A]uthorities from Ontario, while helpful, must be read with caution. The Ontario provision is materially different from the Saskatchewan one [and from the New Zealand and Australian provisions] because of the addition in the Saskatchewan [and New Zealand and Australian] provision of the words ‘of the seller.’ ... the trial court ... must consider the business of the particular seller rather than limit the inquiry to the ordinary course of business in the trade or industry as a whole.

However, provided one is cognisant of this injunction, dicta from Ontario cases remain useful in illustrating those factors that can be relevant to determining whether a sale is ordinary course. The *Fairline Boats* factors relevant to the ordinary course of business generally will still be relevant to the ordinary course of business of a particular seller, but in addition so too will be details of how the particular seller usually conducted its business.

As anticipated in *Fairline Boats*, other cases have added to the list of relevant factors further criteria such as:<sup>45</sup>

- Advertising: if the seller advertises that it sells such goods, a sale is more likely to be ordinary course;
- The nature and significance of the transaction: it ought to be one that a manager might reasonably be expected to carry out on the manager's own initiative without making prior reference back or subsequent report to superior authorities, such as the board of directors or the shareholders;
- The transaction ought not to resemble a liquidation of assets;
- The reason for the transaction: it ought not to have occurred as a response to financial difficulties or in suspicious circumstances;
- The intent of the transaction: neither its intent nor its effect should have been to undermine a security interest;
- The frequency of the type of transaction: an unusual or isolated transaction might be viewed differently from a routine one. On the other hand, mere repetition does not make an otherwise extraordinary transaction ordinary;<sup>46</sup> and
- The arm's length nature of the transaction: a transaction between a company and a party with whom it is related should receive careful scrutiny.

<sup>43</sup> *Alberta Pacific Leasing Inc v Petro Equipment Sales Ltd* (1995) 10 PPSAC (2d) 69 at para 12.

<sup>44</sup> *Camco Inc v Frances Olson Realty* (1979) Ltd [1986] 6 WWR 258 at 276.

<sup>45</sup> See, eg, *Alberta Pacific Leasing Inc v Petro Equipment Sales Ltd* (1995) 10 PPSAC (2d) 69 and 369413 *Alberta Ltd. v. Pocklington* [2001] 4 WWR 423 and the authorities cited therein.

<sup>46</sup> See, eg, *Union Planters Bank NA v Peninsula Bank* (2005) 897 So 2d 499; *Wells Fargo Bank Northwest NA v RPK Capital XVI LLC* [2010] TX App Ct Briefs 565; [2011] TX App Ct Briefs Lexis 148.

Given the variety of factors that have now been held to be relevant, and that could be applicable in any particular case, it will not be uncommon for different factors to point in opposing directions. A balance sheet approach can then be taken with the factors suggesting ordinary course weighed against those that may take the particular sale outside of the ordinary course. This approach implicitly requires the Court to apply a differential weighting to the various factors, rather than simply to count those for and against. While initially there may be some difficulty predicting the outcome of this approach, North American case law provides guidance and we can expect the weighting to become more predictable and transparent as the Australasian case law evolves.<sup>47</sup> Sometimes a single factor may be sufficient to carry the day. For example, the fact that a sale is made only for the purpose of setting off the price against an existing liability, with the consequence that an unsecured creditor is paid ahead of the secured creditor thereby undermining the security agreement, will often take the sale outside of the ordinary course.<sup>48</sup>

## 8. How Relevant is Price?

While price is indubitably relevant when deciding whether a particular sale is in the ordinary course, it is only one of the factors that must be taken into account, albeit an important one. Although cases such as *Fairline Boats* have benchmarked against market price, market price is itself an elusive concept. For example, a sale at a properly advertised public auction could, as a consequence of the auction process, be said to achieve market price on the day but it may nevertheless be an inappropriate price when it comes to determining whether the sale was ordinary course. In many cases, a better benchmark may be the price at which the particular seller usually sells, with due allowance for promotional prices and discounting for obsolete or depreciated goods. A discounted price, even to below cost, will still be regular where it is part of an advertised customary promotion, such as a Boxing Day sale, or the customary disposal of obsolete goods. In other cases, a heavily discounted price, particularly where it is below the seller's cost price, will indicate a non-ordinary course transaction. But because price is only one of the relevant criteria, this factor alone will not be conclusive, just as the converse, a fully priced sale, will not invariably be ordinary course.

In the author's opinion, the New Zealand Courts are at risk of placing an undue emphasis on price, to the exclusion of other relevant criteria, when deciding whether a sale was ordinary course. There appears to be developing in New Zealand a presumption that a sale of inventory will be outside of the ordinary course if it is below market value,<sup>49</sup> and, of more concern, that it will be ordinary course if it is made at a proper price, regardless of any factors that might point the other way. In *Tubbs v Ruby* the Court was apparently influenced by its belief that because the sale was for cash at market value the secured creditor had not been harmed by the sale, noting that "the transactions removed Waimate's inventory from the reach of the Bank's

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<sup>47</sup> A similar evolution took place in New Zealand when the Courts considered the meaning of the ordinary course of business in the context of voidable transactions law under s 292 of the Companies Act 1993 (NZ). Initially this was one of the most litigated issues under the Companies Act but evolved into a reasonably predictable test. Ironically, after it had settled down, the law was changed to do away with the test because of the initial uncertainty.

<sup>48</sup> See further the discussion in para 9 following.

<sup>49</sup> In *Tubbs v Ruby 2005 Ltd* [2010] NZCA 353 at para 37 the Court of Appeal said: "'Market value' would naturally include such usual activities as sales promotions at a reduced price; it is difficult to see how a sale even below such a market value could be in the ordinary course of business."

security, but replaced that inventory with cash,” and later going on to say “[T]here was no need to protect the Bank: the transactions did not diminish, and quite possibly enhanced, the value of its security by less liquid stock being converted into cash.”<sup>50</sup> In the author’s respectful submission, there are two flaws in this analysis. First, it ignores the scheme of the Act, which expressly allows the secured creditor to claim both original collateral and proceeds, as long as there is no element of double dipping,<sup>51</sup> and, secondly, it assumes that the secured creditor got the full benefit of the proceeds. Given that the Court acknowledged that the sales were for the express purpose of assisting the seller’s cash flow,<sup>52</sup> the likelihood is that the proceeds were dissipated paying unsecured creditors of the seller, even if they briefly passed through the seller’s bank account, and did not stay with the Bank. Furthermore, since it appears that all of the sales were later effectively cancelled out by subsequently diverting to Ruby genuine arms-length orders received by Waimate from its customers, the net economic effect of the transactions was artificially to accelerate, or over report, sales by Waimate, which may well have deceived the Bank to its detriment. With respect, the Court of Appeal was right to regard the price, payment mechanism and nature of the goods (the full market price, paid in cash for inventory that the seller was in the business of selling) as factors evidencing ordinariness, but in the author’s submission it gave insufficient weight to countervailing criteria. On the other side of the ledger, the fact that the sales were made to a related party, for the purpose of assisting with the seller’s cash flow, at a time the seller was financially distressed and without delivery of the goods, to a buyer who had no use for the goods, no business, no staff or premises and no means of disposing of the goods other than giving them back to the seller or filling orders received from the seller’s customers clearly demonstrates, it is submitted, that the sales were quite extraordinary. This aspect of the Court’s decision is even more remarkable when one remembers that all that the receivers had to establish was the low threshold of a serious question that the sales were outside the ordinary course.<sup>53</sup>

Ultimately, however, the Court of Appeal granted the receivers the interim injunction they sought. The Court’s analysis described above applied to the bulk of the transactions (which the author will refer to as the initial transactions) but the nature of the transactions altered shortly before the appointment of the receivers. It seems that as Waimate’s financial distress grew, Waimate’s manager used the “Ruby inventory” without swapping it for goods of equivalent value or diverting cash from Waimate’s customers to pay for it. Whether authorised or not, this process left Ruby with an unsecured claim against Waimate in place of the inventory. When the common directors of Waimate and Ruby discovered that Ruby’s inventory had been depleted in this fashion, they set about replenishing it from Waimate’s stock (which the author will refer to as the replenishment transactions). The Court held that arguably the replenishment transactions were either not sales or were outside the ordinary course because they were in satisfaction of an

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<sup>50</sup> Ibid at paras 36 and 38.

<sup>51</sup> See s 32 Aus and s 45 NZ.

<sup>52</sup> [2010] NZCA 353 at para 24.

<sup>53</sup> The author has commented elsewhere on another unsatisfactory consequence of the Court’s decision. The priority Ruby gained (improperly in the author’s view) as a buyer could easily have been legitimately gained by using a purchase money finance device. But in order to do so, Ruby would have been required to register in a timely manner. By characterising Ruby as an ordinary course buyer, whose interest accordingly did not require registration, the Court arguably undermined the registration and publicity objectives of the regime: see Gedye, *The Development of New Zealand’s Secured Transactions Jurisprudence*, (2011) 34 UNSWLJ, 696.

existing obligation and not for cash. This was sufficient for the receivers to succeed at interlocutory level.

### **9. How Not to Analyse the Buyer Protection Provisions: the substantive judgment in *Tubbs v Ruby***

While the author has been critical of the Court of Appeal analysis in *Tubbs v Ruby*, the subsequent High Court judgment in the substantive hearing is even more open to criticism. The Court confirmed that the initial transactions were in the ordinary course of business and then noted that the process by which Ruby's inventory was depleted was an aberration and outside of the ordinary course.<sup>54</sup> But this does not alter the fact that the inventory sold under the initial transactions was gone and was out of the picture. The issue before the Court was whether the process by which the Ruby inventory was replenished was also a sale by Waimate in the ordinary course of its business. If it was not, the effectiveness provisions make clear that the Bank's security interest should have prevailed. If the Court had adopted the starting point suggested in para 2 above, the analysis should have gone something like:

- The goods used to replenish Ruby's inventory initially belonged to Waimate;
- As such, they were subject to the Bank's security interest;
- Pursuant to the effectiveness provisions (s 18 Aus, s 35 NZ), the Bank's interest trumped all comers unless another section of the Act provided otherwise;
- In the circumstances, the only possible provision under which Ruby might prevail would be the provision protecting buyers in the ordinary course of business of Waimate;
- The case accordingly devolved into these two questions: first, was the process of replenishment by way of sale and second, if it was, was it in the ordinary course of Waimate's business.

Instead of adopting such an analysis, the Judge simply said: "When replacing [the inventory] Waimate must have intended that it would belong to Ruby, not Waimate, and I so find."<sup>55</sup> With respect, that is not the test prescribed by the legislation. The Judge's formulation does not address either whether the transaction was a sale or whether it was ordinary. Further, the intention of Ruby is relevant only to the extent that it may assist in determining whether the transaction was intended to operate as a sale. If Waimate had, say, gifted the inventory to Ruby, Waimate would still be said to have intended that the inventory belong to Ruby, but that would not undermine the primacy of the Bank's security interest. The Judge's next comment is also

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<sup>54</sup> [2011] 3 NZLR 551 at paras 46 and 47. It is not clear why the Court even mentioned ordinary course of business in relation to the depletion process. The only issue was whether the replenishment transactions were sales in the ordinary course of Waimate's business. Also, although the Court held that Waimate converted Ruby's timber when it took it without swapping or paying for it, it is not clear that this is correct. Waimate had always been able to use the Ruby inventory provided Waimate substituted equivalent inventory or accounted to Ruby for the sale proceeds. Waimate's taking and not paying could be viewed as a breach of contract but it is not conversion just because Waimate failed to account for the sale proceeds. In fact, it could be argued that Waimate was a mercantile agent of Ruby's and that s 3 of the Mercantile Law Act 1908 (NZ) would apply. Potentially, this could have been relied on by the Bank but it was not argued. The end purchasers from Waimate would be protected from Ruby's claims either by s 3 of the Mercantile Law Act or by s 27(1) of the Sale of Goods Act 1908 (NZ) (seller in possession can pass clear title).

<sup>55</sup> *Ibid* at para 52.

telling: “Effectively, Waimate was returning the [inventory] that it had unlawfully converted.”<sup>56</sup> But it was not the same goods that were being “returned”. The original inventory that had been converted was well gone and the goods used to replenish Ruby’s inventory were entirely new stock that remained subject to the Bank’s security interest unless they were the subject of a fresh sale in the ordinary course of business. Having previously noted the aberrant nature of the transactions by which Ruby’s inventory was depleted, the Judge referred to evidence that as a consequence of the replenishment process “the unauthorised phase of dealing had come to an end and Waimate and Ruby were now *poised* to resume their normal pattern of trading (emphasis added).”<sup>57</sup> The clear implication of this is that the replenishment process was not part of the normal pattern of trading. This which would be one further factor indicating that it was not ordinary. The factors outlined above that the author believes took the initial transactions outside of the ordinary course also apply to the replenishment transactions, but in respect of these transactions the following additional factors further point to this conclusion:

- The replenishment process was undertaken to rectify a course of aberrant and unlawful conduct.<sup>58</sup> Only after this process had been completed were the parties to resume ordinary trading;
- The goods transferred were not paid for in cash. Consideration for the transfer was settlement of a pre-existing unsecured claim for conversion. Some of the Canadian PPSAs make clear that a transfer in total or partial satisfaction of an existing liability does not constitute a sale in the ordinary course of business.<sup>59</sup> It has been suggested that this is designed to prevent an unsecured creditor from “bootstrapping” into priority over a secured party.<sup>60</sup> While there is no equivalent express provision in the Australasian Acts, set-off against an existing liability is still a relevant factor. In Ontario, which similarly does not expressly provide that transfers in settlement of an existing liability are not ordinary course, it has been suggested: “The test, in our view, should be whether the sale would have taken place but for the antecedent debt. If the answer is no, the sale should be treated as falling outside [the ordinary course]. If the answer is yes, it should not be an objection that payment was made by a set-off of debts between the parties since that is a common practice among merchants extending credit in their dealings with each other.”<sup>61</sup> In the instant case, the replenishment transactions would not have taken place but for the unsecured claim for conversion and this alone was sufficient to take them outside of the ordinary course.

The Court did go on to consider the ordinary course test but, with respect, appears to have done so in relation to the wrong transactions. While it is not entirely clear, the Court appears to have

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<sup>56</sup> *Idem*.

<sup>57</sup> *Ibid* at para 53.

<sup>58</sup> “Unlawful” in the sense that it was either conversion or a breach of contract: see note 51 above.

<sup>59</sup> *Eg*, see PPSA (Sask) s 30(8)

<sup>60</sup> See Cuming and Wood, *Saskatchewan and Manitoba Personal Property Security Act Handbook*, Carswell, Canada, 1994 at 239.

<sup>61</sup> Ziegel and Denomme, *The Ontario Personal Property Security Act Commentary and Analysis*, 2<sup>nd</sup> ed, Butterworths, Toronto and Vancouver, 2000 at 232.

applied the test to Ruby's ultimate *disposal* of the replenished inventory.<sup>62</sup> At this level, the test was simply irrelevant. At issue was whether the Bank's security interest remained attached to the inventory when it was *acquired* by Ruby. If it was, Ruby's subsequent disposal of the inventory was conversion of the Bank's property rights, if it was not, the Bank's security interest has already been cut off and it was unnecessary to revisit the test.

Putting it bluntly, the author regards all of the *Tubbs v Ruby* decisions as wrongly decided. But unless and until other courts decline to apply them there remains the prospect that they will be followed and that legitimate security interests will continue to be undermined by secretive related party transactions. Fortunately, there is a simple solution that goes a long way towards protecting secured parties from inappropriate dealings with the collateral. Security agreements should contain clauses both prohibiting related party sales (unless expressly authorised at the time of sale) and declaring them to be outside of the ordinary course of business. Buyers are only protected under the ordinary course provisions if they are unaware that the sale was prohibited. In cases such as *Tubbs v Ruby*, the common directorships and shareholdings would lead to the finding that the buyer had knowledge of the prohibition and could not avail itself of the ordinary course protection. This highlights another weakness in the *Tubbs v Ruby* cases: decisions that can so easily be circumvented by good drafting are unlikely to be enduring precedents.

## 10. Limits to the subjective approach

The Ontario PPSA has adopted the objective standard of the ordinary course of business generally, rather than the more subjective standard of the ordinary course of the seller's business. In applying the Ontario test, it has been held that:<sup>63</sup>

Whether a transaction is in the ordinary course of business ... is a question of fact to be objectively assessed, taking into account all circumstances which were known, or ought reasonably to have been known, to the purchaser. ... It follows that a transaction apparently in the ordinary course of business is within [the section] notwithstanding that circumstances not known or not reasonably within the knowledge of the purchaser at the time of the transaction establish that the dealing was not in the ordinary course of business. In considering whether [the section] applies ... I therefore need not inquire whether these transactions were fraudulent. I need only ask: were they in the ordinary course of business? It also follows that the parties to a security agreement cannot define by their agreement the meaning to be attributed to the words "in the ordinary course of business" for the purposes of [the section].

This passage was taken up in another Ontario decision that noted: "Whether the sale is in the ordinary course of business is determined from the buyer's perspective."<sup>64</sup> But while these sentiments may be consistent with the objective Ontario test, it is necessary to consider whether they can also be applied to the more subjective "business of the seller" test found in the Australasian Acts and the Uniform Canadian PPSAs. Although at first sight it may appear that the best person to know what is the seller's business and modus operandi will be the seller, so

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<sup>62</sup> See para 57 of the judgment. The Judge is dealing with what he refers to as "the October 2009 transactions," which were the transactions by which Ruby disposed of the inventory to Waimate's customers, not the transactions by which Ruby purportedly acquired the inventory free of the Bank's security interest.

<sup>63</sup> *Ford Motor Credit Co of Canada v Centre Motors of Brampton Ltd* (1982) 2 PPSAC 63 at 75.

<sup>64</sup> *Agricultural Commodity Corp v Schaus Feedlots Inc* (2001) 2 PPSAC (3d) 270 at para 16.

that the test would be wholly subjective, regard must be had to the policy behind the test. The rationale for s 46 (Aus) and s 53 (NZ) is to facilitate trade by allowing certain buyers (ie, ordinary course buyers) to buy goods without having to ensure the goods are unencumbered. There are aspects of both “justice and commercial utility”<sup>65</sup> about this so it is not surprising that even under the more subjective formulation of the test it has been held by a Saskatchewan Court that “one can discern a public policy consideration in the legislation which favours the safe guarding of sales transactions over the safe guarding of secured transactions in such a case”<sup>66</sup> and that “ a generally liberal interpretation of the phrase ‘buyer ... of goods sold ... in the ordinary course of business of the seller’ ... to protect the buying public ... where ... goods are sold to the public ... comports with the underlying philosophy of the provision to protect the security interest so long as it does not interfere with the normal flow of commerce.”<sup>67</sup> These dicta indicate that the objective Ontario factual analysis may also be applied in those jurisdictions such as Australia and New Zealand that have adopted the more subjective test. If this is so, although Australia and New Zealand have adopted the subjective “ordinary course of business of the seller” test, the seller’s ordinary course of business would be objectively determined from the buyer’s perspective so that unusual circumstances of which the buyer was not put on notice would not take the sale outside of the ordinary course. The provisions themselves provide some support for this approach. Both s 46 (Aus) and s 53 (NZ) provide that if a sale is in breach of the security agreement, a buyer is still protected unless the buyer has knowledge of the breach.<sup>68</sup> It is thus evident from the structure of the sections that sales in breach of a security agreement can still be in the ordinary course of business. If it were otherwise, there would be no need for the sections to exclude buyers with knowledge of a breach.

Nevertheless, there is surprisingly little case authority on this issue. Fraud provides a stark illustration of the choice that must be made. Intuitively, it is difficult to see fraudulent transactions as ever being in the ordinary course of business. Older cases in a different context lend some support for the view that fraudulent or illegal transactions cannot be ordinary,<sup>69</sup> but the Ontario decisions quoted above clearly state that in the Ontario PPS context, fraud would only impeach an otherwise ordinary sale where the buyer had cause to suspect it. If this objective, buyer centric, approach to analysis of the circumstances surrounding a sale also applies in Australasia, it would render irrelevant provisions in a security agreement that purported to define the seller’s ordinary course of business, unless the buyer was aware of them. But unless and until our Courts rule definitively against the efficacy of contractual provisions describing or limiting the debtor’s ordinary course of business, such clauses can do no harm. To help protect secured creditors from inappropriate dispositions of the collateral, security agreements should define and describe the debtor’s ordinary course of business in terms appropriate to the circumstances (eg, “The retail sale of inventory within the debtor’s usual range of prices to buyers unrelated to the debtor”) as well as expressly providing that any other dispositions are a breach of the security agreement and listing such prohibited transactions. Even if such drafting ultimately proves to be ineffective against unsuspecting buyers, it will still assist

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<sup>65</sup> *Camco Inc v Frances Olson Realty* (1979) Ltd [1986] 6 WWR 258 at 271, considering the Saskatchewan test of ordinary course of business of the seller.

<sup>66</sup> *Ibid* at 272.

<sup>67</sup> *Ibid* at 276.

<sup>68</sup> There is a slight difference in the way the Australian and New Zealand provisions are structured here, but they are to like effect.

<sup>69</sup>

where the buyer had cause to suspect the seller was acting outside the terms of the security agreement, such as where the buyer is a related party. Until then, the only New Zealand case to consider the question suggested such drafting may help to define the seller's ordinary course. In a passing comment, White J stated that "covenants in the security documentation served to limit the authorised scope of [the debtor's] ordinary course of business." Doubtless, future secured parties will seize on this comment to argue that the seller's business can indeed be defined by the security agreement, but there is no suggestion that White J intended to settle such an important question in such a peremptory fashion and it is best regarded as still open. Also, it is worth pointing out that the comment refers to the "authorised scope" of the ordinary course of business. Section 46 (Aus) and s 53 (NZ) deal with what is in fact in the seller's ordinary course of business, not with what the secured party authorises. The latter is governed by the provisions discussed in the next paragraph.

## 11. Sales Authorised by the Seller

Sales or other dealings with the collateral that the secured party authorises, either expressly or impliedly and either in or outside the security agreement, can extinguish the security interest.<sup>70</sup> This is the effect of s 32 (Aus) and s 45 (NZ). Where collateral is sold in the ordinary course of the seller's business, the operation of these sections can overlap with s 46 (Aus) and s 53 (NZ) (the sales in the ordinary course of business provisions). There are various ways of tackling the intersection of these provisions, but they should all lead to the same result.

Where a buyer has any doubt about whether a sale is in the ordinary course of the seller's business, it is prudent to obtain the consent of any secured parties. In this way, the buyer can be assured of acquiring the purchased property free of any security interests held by creditors from whom consent was obtained. The buyer will then obtain unencumbered title by virtue of s 32 (Aus) or s 45 (NZ) regardless of whether or not the sale was in the ordinary course. The most common instance of this will be when a debtor disposes of surplus equipment and the buyer insists on obtaining a release from any secured creditors. But s 32 (Aus) and s 45 (NZ) can also operate when inventory is sold. Inventory financiers generally expect the debtor to sell the inventory and use the sale proceeds to repay the financier. The security agreement may contain express terms authorising such sales, but in the absence of any express authorisation, the authority will generally be implied. It is well established that it is appropriate to imply into a security agreement covering inventory a term that the debtor is authorised to sell the inventory in the ordinary course of its business.<sup>71</sup> Being contractual in origin, the parties are free either to expand or to restrict the scope of this authority. If a broad authority is given, it may operate to give a buyer unencumbered title in circumstances when the statutory ordinary course provisions would not. When the authority is restricted, the issues discussed in the previous paragraph will arise.

But often, the security agreement will make no mention of the debtor's power to dispose of the collateral. It is the author's opinion that in such cases the implied authority to deal with the

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<sup>70</sup> The security interest will not be extinguished where the parties intend that the transferee takes subject to the security interest, perhaps, for example, where the transfer is part of a corporate restructuring and the collateral is transferred to an associate of the debtor who expects to take the collateral subject to the security interest.

<sup>71</sup> For example, see *Insurance and Discount Corporation Ltd v Motorville Car Sales* [1953] 1 DLR 560 at 566 and the authorities there referred to.

collateral should be limited to sales in the ordinary course of the seller's business and that this authority will potentially apply to fewer sales than the statutory ordinary course test. It will potentially apply to fewer sales because a debtor would never have implied contractual authority to act fraudulently or illegally,<sup>72</sup> whereas the Ontario view of the statutory test, discussed in the previous paragraph, is that fraudulent sales may be ordinary course provided the buyer had no cause to know of the fraud. The implied authority should be limited to sales in the ordinary course of business because this is all that is required to give the contract business efficacy.<sup>73</sup> The secured party cannot prevent the operation of s 46 (Aus) or s 53 (NZ) but would have no reason to extend it.<sup>74</sup> However, spelling out expressly in the security agreement the scope of the debtor's right to sell the collateral will put the limits of the contractual authority beyond doubt and is another good reason to include such a provision in the security agreement regardless of doubts about its impact on the statutory authority.

Because any contractual implied term authorising the debtor to deal with the collateral should generally be limited to sales in the ordinary course of business, the overlap between the contractual authority to deal under s 32 (Aus) and s 45 (NZ) and the statutory authority to sell in the ordinary course under s 46 (Aus) and s 53 (NZ) will be of most concern either when the security agreement is silent about the debtor's authority to dispose of the collateral or the security agreement expressly authorises ordinary course sales without further defining or limiting the concept. There will then be two separate provisions of the PPSA, each engaging an ordinary course of business test of potentially different scope to the other, under which a buyer may claim unencumbered title. To simplify the analysis in these circumstances, once it has been established that any express provisions approving the sale of the collateral, given either in the security agreement or subsequently, are no broader than the ordinary course test, s 32 (Aus) and s 45 (NZ) can be largely ignored. The focus should then be on the statutory ordinary course of business test under s 46 (Aus) and s 53 (NZ) because the contractually implied authority will be no wider, and may be more restrictive, than the statutory ordinary course of business test.

## 12. The Australian Twist<sup>75</sup>

In the absence of any other applicable buyer protection provision, it is generally assumed that the scheme of the legislation is to give buyers in the ordinary course of business unencumbered title while other buyers and sub-buyers take subject to perfected security interests. However, depending on the correct interpretation of s 165 (Aus), some seemingly disparate provisions of the Australian Act may, perhaps unintentionally, lead to a different result in Australia. Section

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<sup>72</sup> Ibid at 574.

<sup>73</sup> See *BP Refinery (Westernport) Pty Ltd v Shire of Hastings* (1977) 180 CLR 266.

<sup>74</sup> The troubling New Zealand decision of *Motorworld Ltd (in liq) v Turners Auctions Ltd* [2010] NZCCLR 30 contains conflicting dicta on this point. While the judgment records that "Where a creditor holds a security interest over a debtor's inventory, both parties will generally accept and understand that the debtor may only deal with that inventory in the ordinary course of business," the Judge then held on the facts that the debtor was not subject to any limitation at all in the way it dealt with the inventory collateral (see para 37). It is respectfully suggested this decision should be restricted to its unusual facts. See further the analysis in Gedye, *The Development of New Zealand's Secured Transactions Jurisprudence*, (2011) 34 UNSWLJ, 696 at 725. The author discloses that he advised the unsuccessful secured party in this case.

<sup>75</sup> The author is still developing his analysis of this issue and welcomes any feedback.

165 (Aus) describes some of the defects that can invalidate a registration, potentially rendering a security interest unperfected. New Zealand has an equivalent provision (s 150) but, unlike New Zealand's, the Australian provision refers to defects existing "at a particular time." These words suggest that an initially valid registration may become ineffective sometime later through changed circumstances. This interpretation is consistent with s 166 (Aus), which provides in certain cases for temporary effectiveness of a registration where there is a subsequently arising defect. For example, where the secured party has correctly recorded the debtor's name but the debtor subsequently changes its name, the name change would seem to invalidate the registration under ss 164(1)(b) and 165 (b), but s 166 would then give temporary effectiveness until the end of 5 business days after the secured party became aware of the name change, with a backstop of no more than 60 months temporary effectiveness. This effectively imposes an obligation on the secured party to update its registration when it becomes aware of a change of name of the debtor. This is entirely reasonable and is achieved in New Zealand via a different mechanism.<sup>76</sup> However, temporary effectiveness does not apply where the operative defect results "from a change of the grantor:" s 166(1)(a)(ii) (Aus). While it is not entirely clear, it appears that a transfer of the collateral would result in a change of the grantor and would invalidate the registration under s 164(1)(b) and s 165(b), but that there is no temporary effectiveness under s 166 for this particular defect. The next step in the analysis then seems to go all the way back to s 34. This provides a period of up to 24 months *temporary perfection* in the case of a transfer of the collateral in lieu of the 60 months *temporary effectiveness* under s 166 that applies in the case of a change of name by the debtor. But it seems that temporary perfection is not quite as good as temporary effectiveness because buyers take free of temporarily perfected security interests under s 52 (Aus).

If the author's analysis is correct, the consequence is that in Australia, good faith sub-buyers would defeat otherwise perfected security interests. For example:

Secured Party registers and perfects against Debtor. Unknown to Secured Party, Debtor sells the collateral to Buyer outside of the ordinary course of Debtor's business in circumstances when no other buyer protection provision applies. Buyer accordingly holds the collateral subject to Secured Party's security interest but, by virtue of ss 164 and 165, Secured Party's registration has become defective and is only temporarily perfected under s 34. Buyer resells the collateral to Sub-buyer. Sub-buyer takes the collateral free of Secured Party's security interest under s 52, even during the s 34 period of temporary perfection and whether or not the sale to Sub-buyer is in the ordinary course of business.

This result would not follow in New Zealand while the secured party remained ignorant of the transfer of the collateral from Debtor to Buyer. If the result is correct, the controversial buyer's seller rule discussed in para 5 above effectively will not apply in Australia. Of course, if this is so, one wonders why s 46 (Aus) includes the buyer's seller rule in the first place.

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<sup>76</sup> See s 90(1)(b) NZ.