Retention of Title "Security" Interests 25 years after Romalpa

Professor Berna Collier

Commissioner
Australian Securities & Investments Commission
Brisbane

AUSTRALIAN PERSPECTIVES

Thank you for inviting me to speak at this session of the Banking and Financial Services Law Association Conference. In the context of the discussion of financing stock and debtors, the specific issues upon which we are focusing can best be summarised in the Australian context as fixed charges over book debts, and retention of title clauses. These issues raise interesting questions for a number of reasons.

First, both issues are very topical in Australia. It is fair to say that *Agnew v Commissioner of Inland Revenue*[1] sent shivers down the spines of financial institutions' senior managers and legal advisers in this country. Further, retention of title or "Romalpa" clauses continue to occupy secured creditors and insolvency practitioners in Australia, as evidenced by the continuing stream of litigation involving these transactions. The leading case in Australia on this topic – *Associated Alloys Pty Ltd v ACN 001 452 106 Pty Ltd*[2] – and more recent cases will be examined during the course of this presentation.

Secondly, in considering *Agnew* and *Associated Alloys*, the question arises whether they are in fact philosophically inconsistent. Notwithstanding the different issues arising in the cases, a fundamental question in common appears to be whether, in analysing arrangements in the nature of security, contractual form or substance is to be preferred. Traditionally, of course, equity prefers substance to form. It requires little drilling to note that the Privy Council in *Agnew* adopted the approach that substance was to be preferred, whereas it may be argued that the High Court in *Associated Alloys* preferred form. It may be useful to come back to this issue during panel discussion later in the session.

Finally, it is important to recognise that New Zealand law in this area is diverging from Australian law. The *Personal Property Securities Act 1999* (NZ) has meant that the issues as to fixed charges over book debt and retention of title clauses which so concern Australian lawyers are to a large extent otiose in that jurisdiction. This is an issue which Steve will be addressing after me, and I look forward to hearing his presentation on this topic.

---

[1] (2001) 2 AC 710
[2] (2000) 202 CLR 588

Agnew, Fixed Charges and Book Debts – the Australian position

We have already heard a detailed examination of the Privy Council decision in *Agnew v Commissioner of Inland Revenue*. This is an important case in Australia, not only in the context of being an authoritative restatement of the common law as applies to floating charges and fixed charges, but also as a definition of the property which may properly be encapsulated in a fixed charge. In summary, the Privy Council were of the view that, as a general rule, book debts cannot be the subject of a fixed charge. In this case, the court held that a charge over the uncollected book debts of a company, which leaves the company free to collect debts and use the proceeds in the ordinary course of its business, is a floating charge as a matter of law, and not a fixed charge. This is notwithstanding that the terms of the charge in that case specifically purported to create a fixed charge over the book debts and proceeds.

"Book debts"

A "book debt" can be defined as follows :

> Surely it is an entitlement to payment. Once payment is made by cheque or otherwise, the book debt is extinguished by the payment. Hence the entitlement to the book debt no longer exists. The means of payment of the book debt, for example by cheque, is precisely the means by which the chose in action is satisfied and in that sense the means of payment is part of the book debt. Any other meaning in the present context would be entirely artificial.[3]

Further, they are choses in action, and may be distinguished as a matter of law from the cash proceeds by which they are satisfied.[4]

Legislative impact

In taking security over corporate assets, it is traditional for secured creditors to take a fixed charge over assets of a permanent or semi-permanent nature (for example, plant and equipment), and floating charges over assets which are in a constant state of turnover (for example, stock in trade). Advantages offered by floating charges to creditors have, however, reduced over time with legislation establishing priorities in favour of preferential creditor groups, in relation to assets secured by floating charges. In Australia, examples of this erosion of the priorities of floating charge holders in the *Corporations Act* are

- section 433, which gives priority to floating charge assets to employees and other nominated preferential creditors where a receiver is appointed to the company;
- section 561, which gives priority to employees' claims over floating charges where the company enters liquidation;

[3] *Re Rex Developments Pty Ltd (in liq)* (1994) 13 ACSR 485 at 490

[4] this point was made recently by the High Court in *Associated Alloys Pty Ltd v ACN 001 452 106 Pty Ltd* (2000) 202 CLR 588 in the context of retention of title

- section 443E, which gives an administrator under Part 5.3A priority in respect of his or her right of indemnity to floating charge assets.

The definition of "floating charge" in the *Corporations Act* includes a charge that conferred a floating security at the time of its creation but has since become a fixed or specific charge.[5] Hence, notwithstanding the fact that a floating charge crystallises and fixes to the property, the categorisation of the charge as initially a floating security will mean the postponement of the secured creditor to the rights of preferential unsecured creditors in nominated circumstances.

In order to overcome potential issues of postponement to unsecured creditors, a technique employed by some financial institutions has been to draft a debenture so that, as far as possible, all assets of value of the debtor corporation (in particular, book debts) are subject to a *fixed* charge in favour of the creditor, rather than a floating charge. This approach was endorsed by the English Court of Appeal in *Re New Bullas Trading Ltd.*[6] This drafting technique had met with qualified success in relation to book debts of a corporation, not only in Australia but also in the UK and New Zealand, until the decision in *Agnew.*

Australian courts

The leading Australian case on this issue is the Supreme Court of New South Wales decision of Bryson J in *Whitton v ACN 003 266 886 (controller appointed)(in liq).*[7] In that case the first defendant was a company – originally known as Boswell Printing Pty Ltd – over which Heller Financial Services Ltd had registered a charge.

So far as relevant, the charge provided :

> 3.2 The charges hereby created shall operate as fixed charges as to :-
>
> ...
>
> (viii) All book debts of the Mortgagor, present and future, where the whole or any part of such book debts remains unpaid by the debtor and without limiting the generality of the foregoing all debts which have become, are or shall become owing by any related company of the Mortgagee to the Mortgagor on any account whatsoever...
>
> ...
>
> and shall operate as a floating security only as regards all other assets hereby charged, including monies or property actually received by the Mortgagor on account of any book debt of the Mortgagor PROVIDED ALWAYS THAT the Mortgagor shall not be at liberty without the prior written consent of the Mortgagee to part with or

[5] section 9
[6] (1994) 12 ACLC 3203
[7] (1996) 14 ACLC 1799

dispose of any property or assets charged by way of floating charge except in the ordinary course of its business and for the purpose of carrying on the same.

The charge also prohibited the debtor from dealing with the book debts without the consent of the creditor, and appointed the debtor the agent of the creditor to collect and receive all monies payable in respect of the book debts subject to the fixed charge.

The liquidator argued that if the security did take effect as a fixed charge over book debts and a floating charge over the proceeds, then not only was the value of the security demoted to that of a floating charge once the book debts were realised, but also the relationship of the parties and the transactions between them in relation to the book debts were no different to the position that would have existed had they specifically agreed in the first place upon a floating charge over the book debts.

Bryson J held that the intention of the parties as expressed in their documents should be given effect. The terms of the charge prohibited the debtor dealing with the book debts without the consent of the chargee, and distinguished between the book debts which had not been collected and the proceeds of collection in the hands of the company. Accordingly, Bryson J followed *Re New Bullas*, and held that the charge was fixed in relation to the uncollected book debts, and floating as to the realised proceeds.

Interestingly, other Australian judicial commentary on this topic has been more equivocal. Two cases examining this issue prior to *Agnew* carefully distinguished their respective facts from *Re New Bullas*, and held that similar clauses were ineffective as fixed charges. So, for example :

- in *Mullins v R*[8] the Court of Criminal Appeal in Western Australia held that a fixed charge over book debts actually took effect as a floating charge, because a fixed charge was inconsistent with the freedom of the debtor to recover the proceeds of the book debts, and thus *Re New Bullas* was distinguishable; and
- in *Elgin Abattoir Pty Ltd (in liq) v Elders Burnett Moore (WA) Pty Ltd*[9] the Supreme Court of Western Australia noted that the debtor company was free to collect its book debts and apply them in the normal course of its business. It could not assign the book debts or otherwise dispose of them other than in the normal course of business, but as the book debts provided the primary source of security, this was hardly surprising. In these circumstances Sanderson M held that the security took effect as a floating charge, not a fixed charge.

Since *Agnew* the issue has, to my knowledge, been mentioned in only one Australian case – i.e. *Re Emilco Pty Ltd*[10] decided late last year. The case involved litigation between the liquidator of Emilco Pty Ltd and one of the shareholders over an agreement whereby the shareholder had purchased from the company a chose in action – i.e. a claim by the company against its insurer. A key issue was whether funds recovered by the shareholder should be held on trust for the company. The agreement

[8] unreported Court of Criminal Appeal, Supreme Court of WA, 26 September 1994
[9] unreported, Supreme Court of Western Australia, Sanderson M, 25 March 1997
[10] unreported, Supreme Court of New South Wales, Barrett J, 19 November 2001

included a provision that the shareholder would not sell or otherwise dispose of the chose in action without the consent of the company. Barrett J held that the clear intention of the parties was that the shareholder should participate in the proceeds of successful prosecution of the claim against the insurer only to the extent necessary to make him whole for costs and disbursements actually incurred. Because the proceeds, when received, became subject to such a trust, the *chose in action* as it existed before realisation of its proceeds was also subject to a trust. Barrett J noted that this reasoning was consistent with views of the Privy Council in *Agnew*, specifically

> While a debt and its proceeds are two separate assets, however, the latter are merely the traceable proceeds of the former and represent its entire value. A debt is a receivable; it is merely a right to receive payments from the debtor. Such a right cannot be enjoyed in specie; its value can be exploited only by exercising the right or by assigning it for value to a third party. An assignment or charge of a receivable which does not carry with it the right to the receipt has no value.

While clearly limited conclusions can be drawn from these comments in the context of the fixed charge/book debts debate, one may speculate that an Australian court may be inclined to follow the *Agnew* reasoning rather than that adopted in *Whitton*.

Implications

Agnew is a decision of the Judicial Committee of the Privy Council on appeal from the Court of Appeal of New Zealand. It is not binding on Australian courts. However, it is a decision which will be taken seriously in an Australian court. Not only is it a statement of a superior appellate court of high standing, but it analyses legal principles which are of equal relevance to Australian law. Further, the court considered that *Re New Bullas*, which was the foundation for the body of law endorsing fixed charges over book debts, was wrongly decided. To this extent, the authority of cases including *Whitton*, which followed *Re New Bullas*, must be in some doubt.

If followed in Australia, the result of *Agnew* is that a charge which is fixed as to uncollected book debts but floating as to the collected proceeds of those debts, will be interpreted as floating over the book debts as well. In order to be a fixed charge over the book debts, the debtor must be under genuine restrictions in its ability to collect and, more pertinently, use the proceeds. The Privy Council indicated that a blocked account is one means of creating the environment for an enforceable fixed charge. In commercial practice, however, it is unlikely that financial institutions would be prepared to deal with debtors on this basis. Not only could it in practice lead to the paralysis of the business of the debtor, but the degree of monitoring of accounts which would be required by the creditor would be onerous.

In light of *Agnew*, it is interesting to speculate how Australian courts will interpret fixed charges over book debts. This is a live issue, as the security documentation of a number of financial institutions in Australia contain similar charging clauses to that analysed in *Agnew*. As noted earlier in this paper, some early indications are provided by the *Emilco* case. It is likely that policy issues will play a significant role. In particular, a background issue of key importance is the fact that in many cases, the

dispute will be between the major secured creditor of an insolvent company, and the unpaid employees who have lost their employment and entitlements on the insolvency of the company. It is possible that this issue may be of some influence to a court in reaching a decision as to whether the charge in question is fixed or floating, in view of the consequent implications for priorities under the *Corporations Act*.

To date the courts appear to have adopted a legalistic approach to the interpretation of debentures asserting fixed charges over book debts.[11] It remains to be seen however whether the recent large corporate collapses in Australia, and policies adopted by the federal government to buffer employees in this event,[12] will have an impact on judicial consideration of drafting devices in security documentation, which affect recovery by employees of their entitlements in the event of the insolvency of their employer. It also remains to be seen, of course, whether this issue will become otiose through legislative initiatives – the Commonwealth government is committed to introducing legislation which gives employees priority over the holders of charges in the event of insolvency.

Retention of title – the current state of play

Litigation involving "Romalpa" or retention of title (ROT) clauses continues to occupy insolvency practitioners and creditors. ROT remains predominantly a common law issue in Australia in the sense that, while ROT is supported by the State sale of goods legislation, the relevant principles have developed through the courts. Reform and rationalisation of personal property security laws, while it has taken place in New Zealand, appears unlikely in Australia in the foreseeable future.

Only one case involving ROT has progressed to the High Court of Australia – that is *Associated Alloys*. The decision was important for that reason alone, however it has also been ground breaking in the development of equitable principles associated with retention of title. Since *Associated Alloys* a number of cases have been considered in superior courts throughout Australia, issues decided by the High Court were not directly applied. It is useful however to briefly consider both *Associated Alloys* and the more recent cases considered by the State courts, not only by way of update but also to identify trends in the law associated with ROT, which at the best of times can be a difficult area of law.

Now that the dust has settled – Associated Alloys Pty Ltd v ACN 001 452 106 Pty Ltd

In *Associated Alloys Pty Ltd v ACN 001 452 106 Pty Ltd* the High Court endorsed a Romalpa clause allowing a seller to trace proceeds of sub-sale of products, manufactured from the original goods, in the hands of the buyer.

---

[11] Query whether *Re New Bullas* ignored policy considerations : see E Emmett "Re New Bullas Trading Ltd – The Evolving Floating Charge" (1995) 13 *C&SLJ* 203 at 210

[12] for example, the *Corporations Law Amendment (Employee Entitlements) Act 2000* (Cth)

For at least eleven years prior to this decision, cases in both Australia and elsewhere had supported the principle that a clause in this form created an unregistered charge over the assets of the buyer, and hence was void as against an administrator or liquidator under section 266.[13]

The case has significant implications for other creditors of the buyer – in particular, secured creditors and priority creditors – who will be unable to access money in the hands of insolvent companies, but "traced" by suppliers of those companies under properly drafted ROT clauses.

Briefly, Associated Alloys Ltd ("the seller") had sold steel to Metropolitan Engineering and Fabrications Pty Ltd ("the buyer" – this company was later known as ACN 001 452 106 Pty Ltd) for several years. Usually, an ROT clause was printed on the back of invoices issued by the seller to the buyer. The clause contained five sub-clauses. The only one at issue in this case was sub-clause 5 – i.e.

> "In the event that the [buyer] uses the goods/product in some manufacturing or construction process of its own or some third party, then the [buyer] shall hold such part of the proceeds of such manufacturing or construction process as relates to the goods/products in trust for the [seller]. Such part shall be deemed to equal in dollar terms the amount owing by the [buyer] to the [seller] at the time of the receipt of such proceeds."

The buyer used the steel to manufacture pressure vessels, heat exchangers and columns, which it sold to a company in Korea. The buyer had not paid the seller an amount owing under particular invoices. It was clear from the facts that the steel supplied by the seller to the buyer had been used to manufacture these products for the Korean company.

The buyer subsequently entered liquidation, and the seller claimed entitlement to proceeds in the hands of the buyer relating to sale of products made from steel supplied.

The High Court unanimously upheld the earlier decision of the Court of Appeal of New South Wales dismissing the claims of the seller. The majority however found in favour of the seller on the law, but refused to overturn the decision of the lower court on an evidentiary issue. Accordingly, notwithstanding the outcome, the decision endorses the tracing clause in the contract and the position taken by the seller.

In summary, the majority held :

a. The principles of equity permitted the effective drafting of a ROT clause allowing the seller to trace proceeds of sub-sale by way of trust.

b. The seller could not retain title to any proprietary interest in the steel it supplied under the invoices – the steel was no longer capable of being ascertained in the products manufactured by the buyer.

c. On these facts, "the proceeds" meant moneys actually received by the buyer, not book debts. The High Court left open the possibility that a tracing clause could be drafted to encompass book debts of the buyer. However, the High Court recognised that if "proceeds" did not include book debts, the buyer could assign its book debts and thus defeat the operation of the clause. Alternatively,

[13] see, for example, *Tatung (UK) Ltd v Galex Telesure Ltd* (1989) 5 BCC 325 and *Chattis Nominees Pty Ltd v Norman Ross Homeworks Pty Ltd (Receiver Appointed) (in Liquidation)* (1992) 28 NSWLR 338

even if "proceeds" did include book debts, the buyer could avoid the effects of an ROT clause by entering into a forward sale agreement for goods it had yet to manufacture, so that there were never any "book debts" in relation to the goods it was to manufacture. In such circumstances, the buyer would never receive proceeds of sale, and the ROT clause could never fix on the "proceeds".

d. The fact that the "trust" was created by contract was not a problem – the Court pointed out that a contractual relationship is a common base for the establishment or implication and definition of a trust. Similarly, the fact that the property subject to the trust was a proportion of the proceeds received by the buyer was acceptable.

e. In this case the existence of a trust was explicit – this was no sham arrangement between the parties.

f. The inclusion of a period of credit was not inconsistent with a trust – it prescribed the period within which the seller, as beneficiary, could call on the trust property.

g. The debts owed by the buyer to the seller was discharged when a trust was constituted under this clause. Accordingly, it appears that once the buyer used the goods in a process of manufacturing and resold the products, the seller could no longer sue the buyer for the debt owing, but was limited to an action in equity to trace the proceeds of resale.

h. As the clause was not a charge within the meaning of the *Corporations Act*, it was not void as against the administrators or liquidator of the buyer.

The decision in *Associated Alloys* impacts on the practices of suppliers, buyers, lenders and insolvency practitioners. Sellers have inevitably taken advantage of the opportunities offered by the case to redraft their ROT clauses, however insolvency practitioners need to be aware of the decision in dealing with claims of suppliers, and in taking action on behalf of creditors. Issues which were not addressed by the case include :

- What is the position where products manufactured by a buyer are an amalgam of several goods supplied by different suppliers, each with "tracing" ROT clauses?
- What is the position where a supplier supplies goods which become fixtures to land, but the supplier seeks only to trace the proceeds of sale if the land is resold, and is not otherwise claiming an interest in the land?
- Would a broader ROT clause – i.e. whereby a supplier supplied property subject to a ROT tracing clause, but sought to take a trust over all proceeds of resale – be enforceable?
- How do the tracing ROT clauses sit with all-moneys ROT clauses?
- To what extent will an ROT clause in this form be of assistance to a supplier where the proceeds of resale of end products are absorbed into and mixed with the general funds of the buyer, making tracing difficult?

One possible consequence is that financial institutions will find the process of ascertaining the credit-worthiness of customers more difficult, and the enforcement of security may be prejudiced by suppliers enforcing tracing remedies against funds in the hands of a buyer/customer. However in practice this may not prove a problem in circumstances where tracing remedies of suppliers are difficult to enforce through extensive mixing of monies by the buyer.

Finally, priority creditors such as employees may be unable to recover from money representing those proceeds, as the money will be outside the operation of the *Corporations Act*. It is unlikely that employee entitlements legislation in its current form will protect funds, which would otherwise be distributed to employees of an insolvent company, from claims by suppliers under ROT tracing clauses similar to the clause upheld in the *Associated Alloys* case.

The High Court recognised the practical difficulties which financial institutions may face, however observed that "these difficulties are capable of remedy by legislation." As already noted earlier in this paper however, legislative remedies have not been swiftly forthcoming.

Retention of title – more recent developments

Since *Associated Alloys*, to my knowledge a number of cases have come before the courts on issues related to ROT. In summary, these cases are as follows :

- *Barrymores Pty Ltd v Harris Scarfe Ltd (Administrators Appointed).*[14] In this case the receivers of a company which was also in administration were entitled to rely on the fact of the administration to require the vendor of goods under an ROT clause to comply with Part 5.3A *Corporations Act*. Practically, this meant that ROT goods in the possession of the receivers, for which no payment had been made, were "property of the company" for the purposes of section 440D *Corporations Act*, and the vendor was required to apply to the court for leave to recover possession of the goods. The Court made it clear that in circumstances where the supplier was seeking to recover goods which had been supplied to the company prior to the appointment of the receiver, it is not possible to divorce the company from the proceedings. Where the company is in administration, the processes for leave to proceed envisaged by Part 5.3A must be satisfied. Further, the receivers will have limited protection in such circumstances from an action in conversion by disaffected ROT creditors. However Roberts-Smith J was prepared to grant leave to the vendor on the basis that a company which is solely under administration is in a different position to that where the company is also in receivership.

- *Radio Frequency Systems Pty Ltd v Guthrie (as Liquidator of ULT Ltd (Receiver Appointed) (in liq).* [15] In this case goods had been supplied by a vendor pursuant to terms whereby ownership passed to the purchaser prior to payment. After the purchaser developed financial problems the vendor requested the purchaser to execute a credit agreement containing an ROT clause, backdated several months to include goods which had been supplied and remained unpaid. The

[14] (2001) 162 FLR 258 (Supreme Court of Western Australia)
[15] unreported, Supreme Court of Western Australia Full Court, Steytler, Miller JJ and Pidgeon J AUJJ

purchaser subsequently paid the vendor for goods which had been supplied, and in which ownership had revested in the vendor. Subsequently the purchaser went into liquidation. The court at first instance held that the payments were insolvent transactions and void against the liquidator, however this decision was overturned by the Full Court of the Supreme Court of Western Australia. The Court held that the agreement was effective to revest ownership of goods supplied, it did not take effect as a security, and there was no suggestion that it was a sham. Essentially, there was no difference between goods supplied prior to and subsequent to the execution of the credit agreement.

- *York International Australia Pty Ltd v Heller Financial Services Pty Ltd.* [16] The terms of sale of a chiller for an air conditioning system included an ROT clause, which provided that property in the goods remained with the vendor until either the purchaser had paid for the goods, or the goods were resold to a sub-purchaser. The chiller was, on the instructions of the purchaser, delivered to the sub-purchaser, and the sub-purchaser paid for the chiller by cheque, giving the cheque to the purchaser. Rather than pay the cheque to the vendor however, the purchaser deposited the cheque into the bank account of a third party with whom the purchaser had a debt factoring agreement. When the purchaser became insolvent the vendor sued the third party and the bank for conversion of its cheque. The court held that the ROT clause operated only in respect of a bailment between the vendor and the purchaser. In this case no bailment took place between these parties – the chiller was delivered directly to the sub-purchaser. The clause did not give vendor the right to sue for conversion of the cheque in the events that occurred, which in the view of the court was to the purchaser's misfortune.

- *BHP Steel Ltd v Robertson (Australia) Pty Ltd (administrator appointed).*[17] The proceedings involved a determination of the ownership of steel products which had been sold by the vendor to the purchaser, and then resold to the sub-purchaser when the purchaser sold its business to the sub-purchaser. The question went to the capacity or capability of the contract between the vendor and purchaser, on its proper construction, to have the effect of retaining to the vendor legal and beneficial property in the product notwithstanding a later purported sale of that product by the purchaser to a third party. Barrett J held that the contract did not have that capacity or capability. Further, like the High Court in *Associated Alloys*, the court was of the view that an ROT clause dealing with the proceeds of a manufacturing or construction process entailed a permission for the customer to use or incorporate the goods in that way. In other words, the specification about the treatment of the proceeds of the particular activity which would otherwise have been a conversion or breach of bailment carried with it a licence to engage in that otherwise wrongful activity. Words such as "the customer may incorporate the goods into something produced by a manufacturing process" were obviously not seen as necessary to justify the finding of permission to incorporate.

[16] unreported, Supreme Court of Victoria, Court of Appeal, Charles, Callaway and Buchanan JJA, 19 April 2001
[17] unreported, Supreme Court of New South Wales, Barrett J, 19 April 2002

Conclusion

The law in respect of fixed charges over book debts, and retention of title, remains difficult and unsettled in Australia. Law reform in relation to both issues would be helpful. This contrasts with the situation in New Zealand, where the law has been substantially reformed in relation to corporate securities, and indeed preferential creditors rank above any charge over book debts. A common feature of the *Agnew* and *Associated Alloys* case however is that both decisions weaken the position of secured creditors, vis-à-vis preferential creditors in the first case, and unsecured vendors of goods in the second. Predicting the result in any particular litigation however will continue to be a challenge.

I will now hand you back to the Chair of the session and our third speaker who will be dealing with some these issues from the New Zealand perspective.