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PPS: Specific Issues - Chaos In The Making.....

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PPSA in Australia – Chaos in the Making, or Brave New World?

PURCHASE MONEY SECURITY INTERESTS

> *A purchase money security interest (PMSI) is afforded a super priority under an Article 9 scheme. There are good commercial reasons for the super priority. First, the transaction is economically neutral. Secondly, to allow the holder of a prior registered security interest priority would result in the first being unjustly enriched at the expense of the second.*

The rationale for the purchase money security interest is bound up in the monopoly that the first in time priority lender enjoys because of the after-acquired property clause that is enshrined in PPS. A security interest attaches to new property without the requirement for any new act or transfer or appropriation by a debtor[1]. A security agreement that includes an after-acquired property clause[2] will result in any newly acquired property attaching to the security interest, it will automatically attach to new inventory (stock in trade) or accounts (book debts). Accounts usually represent the proceeds of the sale of stock in trade or inventory. Future advances are automatically tacked to the first priority by operation of s18(4).

Article 9 greatly improved the lot of the North American financier to take security over after-acquired property and their proceeds, which did not have the equivalent of the fixed and floating charge principally because of *Benedict v Ratner*[3]. Under the doctrine established in this case, unfettered dominion over the collateral and proceeds of a debtor was voidable as a fraudulent conveyance in bankruptcy. The floating lien is now firmly embedded in Article 9 and is not too dissimilar to the equitable charge over all present and future (after-acquired)

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1 S18(3).

2 S18(2).

3 268 US 353 (1925).

property that automatically attaches to the debtor's newly acquired assets without the need for any specific act of appropriation or execution of a new charge. This has been recognised under the common law and equitable rules since *Holroyd v Marshall*[4] and *Tailby v Official Receiver*[5]. There are obvious advantages in having the concept enshrined in legislation as this adds the certainty of the legislative basis and also hopefully sets the rules that apply to the PMSI.

The after-acquired property clause coupled with the first in time priority rule gives the first in time a monopoly over and, therefore, a competitive advantage over subsequent lenders. Gilmore[6] described this competitive advantage as the 'whole-hog after-acquired property clause'.

The first characteristic of a PMSI is that it was introduced to soften a 'situational monopoly' and enable a debtor to obtain finance on competitive terms[7].

Jackson and Kronman describe the after-acquired property clause as a 'situational monopoly'[8]. The authors also describe a PMSI as "an enabling loan—a loan that makes it possible for [a] debtor to acquire rights in property that he did not previously have"[9].

The second characteristic of a PMSI is its limitation to loans that can be traced to identifiable, discrete items of property. Barkley Clark[10] says the key to a PMSI is to find a direct nexus between the loan proceeds and the collateral.

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[4] (1862) 10 HL Cas 191. Generally, there is no difficulty in creating fixed and specific charges over a company's fixed assets such as plant and equipment, machinery, patents, business premises, land, etc, whenever acquired because of *Holyroyd v Marshall*, which decided that a lender acquires or has vested in it an equitable proprietary interest in the assets of a company immediately the company acquires the asset whether they be present or future assets.

[5] (1888) 13 App Cas 523.

[6] Gilmore, G: *Security Interests in Personal Property*, vol 2, page 779.

[7] T Jackson and A Kronman, *Secured Financing and Priorities Among Creditors* (1979) 88 Yale LJ 1143 at 1164-71.

[8] Ibid, p 1167.

[9] Ibid, p 1165.

[10] B Clark, The Law of Secured Transactions under the Uniform Commercial Code 2 ed 3.09[2][a].

A PMSI only applies to after-acquired property if the purpose of the finance is to enable the debtor to acquire the asset and only to the extent that the funds are actually used by the debtor for that purpose for the logical reason that the debtor does not have title until after the funds are advanced or the credit given.

An article 9 regime does not give a debtor the right as against an earlier secured party to go out and obtain finance if the earlier security agreement prohibits further secured transactions absolutely or without prior consent. A breach of a negative pledge clause in the earlier security agreement will, as now, trigger an event of default entitling the earlier secured party to exercise its rights of enforcement, although the existence of a PMSI will not entitle the earlier secured party to proceed against the PMSI collateral because of the super priority afforded to the PMSI.

Anglo-Australian law has long recognised the purchase money security interest but it was not until *Abbey Building Society v Cann*[11] that the idea that there was a *scintilla temporis* was dispelled by the House of Lords and it was generally regarded that the purchase money security interest lender had priority over an earlier equitable mortgage[12].

The Bill[13] defines the purchase money security interest in section 14, unlike the New Zealand Personal Property Securities Act 1999 which deals with it in the definitional section[14]. The Bill clarifies certain matters but also includes a large amount of unnecessary and confusing verbiage.

Section 14 contains the following definition:

(1) A *purchase money security interest* means of the following:

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[11] [1991] AC 56. See also *Wilson v Kelland* [1910] 2 Ch 306, *Re Connelly Bros Ltd (No.2)* [1912] 2 Ch 25; *Sogelease Australia Ltd v Boston Australia Ltd* (1991) 26 NSWLR 1, *Security Trust Co v Royal Bank of Canada* [1976] AC 503, *Composite Buyers Ltd v State Bank of New South Wales* (1990) 3 ACSR 196 and *B & B Budget Forklifts Pty Ltd v CBFC Ltd* (2008) 13 BPR 25,419 on the effectiveness of a PMSI.

[12] See reservations about the effectiveness of PMSI without a statutory basis in RM Goode, Legal Problems or Credit and Security (3ed) 2003 at 190-193. Cf Ng G, Built on Quicksand: the purchase money security interest under the general law (2006) 80 ALJ 53-67.

[13] *Personal Property Securities Bill* 2009 (Commonwealth)

[14] S16.

(a) a security interest taken in collateral[15], to the extent that it secures all or part of its purchase price;

(b) a security interest taken in collateral by a person who gives value for the purpose of enabling the grantor to acquire rights in the collateral, to the extent that the value is applied to acquire those rights;

(c) the interest of a lessor or bailor of goods under a PPS lease;

(d) the interest of a consignor who delivers goods to a consignee under a commercial consignment.

Exceptions

(2) However, a *purchase money security interest* does not include:

(a) an interest acquired under a transaction of sale and lease back to the seller; or

(b) an interest in collateral (as original collateral) that is chattel paper, an investment instrument, an investment entitlement, a monetary obligation or a negotiable instrument; or

(c) a security interest in collateral that (at the time the interest attaches to the collateral) the grantor intends to use predominantly for personal, domestic or household purposes.

Transactions included

The definition covers two main kinds of financing transactions. *First*, the interest of a *seller* in order to secure payment of all or part of the unpaid purchase price of property sold and, *secondly*, security interests taken by financiers for the purpose of permitting the debtor to acquire new assets. The definition also extends to deemed security interests, consisting of PPS leases and commercial consignments.

Section 14 makes it clear that the obligation secured by a PMSI is not limited to the purchase price or part of it but also extends to any credit charges or interest[16]. This is problematic because the secured party will also want to have his recovery costs included as well[17].

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[15] The words 'by a seller' have been wrongly omitted. Those words are necessary also because of deemed security interests, namely, a PPS lease and consignments.

[16] S14(1) refers to 'all or part' or 'to the extent that value is applied'; and s14(8) refers to credit charges and interest payable.

[17] Cf definition of advances in s 10 includes costs of recovery and enforcement of the security interest.

Sale and lease back transactions excluded

Both s14(2)(a) and s16 (NZ) *exclude* a transaction of sale and lease back to the seller. The reason why a sale and lease back to the seller is excluded is because PPS does not apply to a transaction that is an outright sale and a genuine lease as there is no addition to the debtor's pool of assets[18]. No security interest arises despite the term of the lease.

Further, if the sale and lease back are not genuine but amount to a disguised secured loan involving the seller as borrower and the collateral is goods being sold there can be no sale to which a PMSI can attach.

Priority of PMSIs

Section 62 deals with priority of PMSIs. New Zealand's equivalent is section 73. The Bill allows 10 days to perfect by registration of a filing statement or the date of possession (NZ is the same) in the case of goods. Article 9 (§9-324(a)) is 20 days or the date debtor obtains *possession.* Generally under the Canadian legislation it is 15 days[19]. In the case of intangibles it is the date the purchase money security interest *attaches.*

The super priority of a PMSI also extends to proceeds. This is explicit in s62(2) in the case of inventory and s62(3) in the case of non-inventory collateral.

Procedure

PMSIs in goods that are not inventory.

Priority is gained if the security interest is registered (s62(3)(b)) and also the filing statement contains a statement[20] that the interest is a purchase money security interest (s62(2)(c)). A different rule applies depending upon whether the collateral is goods or other property ie intangibles. A secured party who

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[18] Cuming, Walsh and Wood , *Personal Property Security Law* (2005) p 332.

[19] Saskatchewan s34 – 15 days, Ontario is 10 days.

[20] The filing statement must comply with item 7 of the table in s153 by describing the class of collateral prescribed by the regulations.

holds a PMSI in goods as collateral that is not inventory is afforded priority over every other security interest in the same collateral that is not a PMSI if the security interest in the PMSI is perfected by registration within 10 business days: s62(3)(b)(i). The 10-day period operates from the date of possession in the case of goods. If the collateral is property (intangibles) other than goods priority is gained if the security interest *attaches* to the collateral within the 10-business day period. The reason for the different treatment is because intangibles are not capable of being possessed. Inventory is treated differently because of the cut off rule that applies to buyers in the ordinary course of business.

A PMSI priority will be lost if there is an invalidating error in the filing statement such as an error in the serial number or the collateral is not described in the manner prescribed. Errors can be corrected so long as the financing change statement is lodged within the 10-day period. It is also possible to have the time for filing extended (s293).

The general priority rule requirements for serial numbered goods also apply equally to non-serial numbered goods (ss44 and 45). Motor vehicles held as inventory are not required to be described by serial number as this would impose an administrative nightmare. Also it is unnecessary to protect third parties as buyers and lessees take in the ordinary course of business except those who intend to hold the motor vehicles as inventory (eg s45(2)).

Note that unlike NZ and Canada goods or intangibles such as motor vehicles that are held as consumer goods do not enjoy purchase money security status (s14(2)(c)). The policy for this exception is not clear. Presumably it is because the policymakers believe that a consumer would not have given a prior general security in favour of a financier. Certainly there appears to be no reason given in the Explanatory Memorandum that accompanies the Bill. Canada requires some goods to be described by serial number if held as consumer goods.

Policy behind registration by serial number is to ensure that a potential secured party can search with a high degree of confidence that a search would disclose a PMSI. This expectation is undermined if it is not possible to search in this way.

If inventory is perfected by possession rather than registration, the priority rules will not apply as the debtor never obtained possession. If the goods are later to be given to the debtor, registration by filing should be effected before possession in order to attract the super priority.

Requirement for possession as a debtor

What is the date for possession under s62(3)(b)? The section uses the words "before the end of 10 business days after . . . the day, the grantor, or another person at the request of the grantor, obtains possession of the property". A potential problem arises with this wording. What is the situation where debtor obtains possession of a printing press on a trial basis to determine whether it meets the debtor's needs? Some assistance is gained from the opening words in the section 'the purchase money security interest is perfected". These words imply that in order that time begins to run, the debtor must have granted a security interest in the goods. In other words the debtor must be obligated under a security agreement before time begins to run. Therefore time will only begin to run after the debtor has signed a security agreement agreeing to purchase the printing press. This because when the debtor first gained possession of the printing press he did so for evaluation purposes and not as a debtor[21].

The usual practice in Australia, at least in relation to cars, is that the debtor signs a security agreement (lease or hire purchase) that is subject to acceptance by the financier. The debtor takes possession of the car only after the financier has approved the finance and paid the dealer. If the agreement provides that the

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[21] *Guaranty Trust Co of Canada v Canadian Imperial Bank of Commerce* (1989) 2 PPSAC (2d) 88 (On HCJ). See the discussion on this point in J.S. Zeigel & D.L. Denomme in The Ontario Personal Property Security Act: commentary and analysis 2ed (2000) at 33.8 where the authors state that the Ontario Act was amended to include the words "as a debtor" to ensure that the position decided in *Guaranty Trust* was made explicity clear in the Act.

owner may accept the debtor's offer by signing the agreement and/or paying the dealer, the date will be determined by reference to the date of signature by the financier. In a Canadian case[22], the court decided that the relevant date was the date of approval and not the date of signature of the security agreement.

Security Interests taken by sellers

S14(1)(a) deals with PMSIs taken by sellers. The words 'by a seller' have been deleted from the Bill. Security interests covered are those involving a sale on credit to secure the unpaid purchase price. The equivalent to the decision in *Wilson v Kelland*[23] which involved a sale of freehold property where the vendors agreed to let part of the purchase money remain on mortgage.

As mentioned above, a sale and leaseback is excluded. Sale and repurchase arrangements are also excluded for the same reason that the debtor's security pool is not enhanced[24].

In *Wheatland*[25] a combined harvester had been damaged in a fire and the owner (Baschuk) did not have the funds to repair it. The Baschuk sold the harvester to Ford Credit. Baschuk then sold the goods to Wheatland and later repurchased it from Wheatland. Bachuk obtained finance from Ford Credit. The security agreement was then assigned to Wheatland by Ford Credit. The Court looked at the substance of the transaction and said that there was no enhancement of the buyer's asset pool. From its inception, the underlying purpose of the transaction was to obtain funds in order to repair the harvester. The court said that the impugned transaction did not create a PMSI, but merely created the appearance of the same.

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22 *McLeod & Co v Price Waterhouse Ltd* (1992) 3 PPSAC (2d) 171 (Sask QB); 101 Sask R 115. See also the discussion of this issue at 73.5 of Gedye, Cuming and Wood, Personal Property Securities in New Zealand (2002).

23 [1910] 2 Ch 306.

24 *Wheatland Industries (1990) Ltd v Baschuk* (1994) 8 PPSAC (2d) 247 (Saskatchewan QB).

25 Supra.

It is clear that a sale of goods on credit on an unsecured basis does not create a security interest. An agreement to grant a security interest after the sale cannot create a PMSI simply because on the sale the goods become the property of the buyer who at the time the security interest is granted is already the owner.

Enabling Loans[26]

In order for a lender to obtain a PMSI in collateral two conditions must be satisfied. *First*, the *purpose* of the loan of value must be for 'enabling the debtor to acquire rights in the collateral' and, *secondly*, the *value* must have been applied to enable debtor 'to acquire those rights' in the collateral.

It is unnecessary for the security agreement to contain a provision that the purpose of the loan is to acquire x or y so long as the purpose and application of the value to the acquisition of asset can be established by other means but it might be prudent to do so to avoid potential problems later on.

The language of the section implies that the loan proceeds must be actually used to pay for all or part of the new asset acquired, ie applied towards the enhanced pool of assets. It is best if the funds are paid directly to the seller of the goods or by direct credit to an account of the seller or by cheque payable to the seller.

Mixed value

Difficulties can arise where the funds are paid directly to the debtor and mixed with the debtor's own funds. If a dispute arises between secured parties, problems could arise because of the rule in *Re Hallett's Estate*[27]. This rule presumes that the debtor's funds are used first. If the debtor uses its own money to pay its creditors and also uses money from the PMSI lender's advance so that the amount of the advance is used in total or in part, then problems can arise.

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26 The term coined by Jackson and Kronman, *op cit.*

27 (1880) 13 Ch D 696 (CA).

This is illustrated by the following example taken from Cuming Walsh and Wood:[28]

> SP makes a loan to D to enable D to acquire a new rock crusher. A cheque for $20,000 is made payable to D who deposits it to D's bank account. At the time of the deposit, D has $30,000 credit balance in D's account. D withdraws $40,000 to pay a creditor. Later D deposits $10,000 from a third party source. D then withdraws $20,000 from D's account to pay for the rock crusher.

It is clear in this example that the purchase money advance has been reduced because under *Re Hallett's Estates* the debtor is presumed to have used his own money first and further withdrawals reduce the purchase money advance. The replacement $10,000 does not have the effect of replenishing the purchase money funds which have been reduced to $10,000. The result is that the purchase money security provider's PMSI priority is reduced to $10,000 because only $10,000 of the original advance was used to acquire the rock rusher[29]. This is conclusion is borne out by the words *"to the extent that* value *is applied to acquire those rights*" in s14(1)(b). S16(7) appears to be otiose.

Reimbursement

A typical transaction that is problematic and is not necessarily intended to be covered by the s14 is one involving a loan sought by debtor to buy a big ticket item where the debtor has already paid the deposit. The debtor not only wants the bank to finance the balance but the debtor also wants the bank to lend it additional moneys to reimburse it for the deposit already paid from company funds. Reimbursement of deposit moneys paid by the debtor to acquire goods cannot be an enabling loan because the debtor had already taken possession of the goods.

It is a difficult question from a policy viewpoint whether a purchase money priority should be given where a debtor gets a loan to pay off an open account.

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[28] *Op cit*, p 333.

[29] An example where the court have used the tracing principles is *Michigan National Bank v Flowers Mobile Homes Sales, Inc* 217 SE2d 108 (NC Ct App 1975).

The US courts have decided that a loan by a bank to a purchaser of cattle being bought on an open account from a seller did not give the bank a purchase money security because the loan was merely to pay off a debt because the purchaser already owned the cattle at the time the loan was advanced[30].

Other courts have decided that it is sufficient if there is a close nexus between the purchase and the loan[31]. This basically means that the enabling loan process is two steps in a single transaction. It presupposes that the loans were planned from the beginning whereby debtor arranges a firm loan commitment with his bank to finance the goods in question, acquires the goods and then uses the lenders advance to pay the seller[32]. One view is that a loan arranged later after acquisition of goods is not regarded as an enabling loan[33].

It would seem that a loan arranged with a bridging financer enjoys purchase money security status. In order to attract purchase money security status it is necessary also to arrange a binding commitment with the later financier to pay out the bridging financier. The Saskatchewan Court of Appeal[34] decided that so long as there is a binding commitment by the later financier before the goods are acquired with the bridging financier's money, the bridging loan should be regarded as the first step in a two-step process that enables the debtor to acquire rights in the collateral. This is so despite the fact that the later financier's money was not used to pay the seller.

Professor Gilmore[35] is of the view that *"If the loan transaction appears to be closely allied to the purchase transaction, that should suffice. The evident intent... is to free the purchase money concept from artificial limitation; rigid adherence to particular formalities and sequences should not be required"*.

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30 *North Platte State Bank v Production Credit Association of North Platte* 200 NW2d 1 (Neb 1972) discussed in B Clark *ibid* 3.09[2][a]. See also *ITT Commercial Finance Corp v Union Bank & Trust Co of North Vernon* 528 NE2d 1149 (Ind Ct App 1988)

31 *General Electric Capital Commercial Automotive Finance, Inc v Spartan Motors Ltd* 675 NYS 2d 626 (1998)

32 *Thet Mah and Associates Inc v First Bank of North Dakota (NA), Minot,* 336 NW 2d 134 (ND 1983)

33 *In Re Hansen* 85 BR 821 (B Ct ND Iowa 1988)

34 *Agricultural Credit Corp of Saskatchewan v Pettyjohn* (1991) 79 DLR (4th) 22

35 *Op cit*, Vol 2 782.

Golden Rule is always pay the seller

Despite this Gilmore still counsels that no lender in his right mind will deliberately experiment with how much play there may be in the joints of the section; he will make his loan before acquisition and he will make it direct to the seller.

Deemed Security Interests

Subsections 14(1)(c) and (1)(d) make it clear that the interest of a lessor or a bailor and that of a consignor also enjoy purchase money status. So long as the procedural requirements are met, the lessor, bailor or consignor will enjoy the super priority of a PMSI.

Priority Rules

The general priority rule is set out in section 62(1). This provides that a PMSI will have priority over a general security interest in collateral or proceeds subject to compliance with subsection (2) in the case of inventory and subsection (3) in the case of a non-inventory PMSI. Section 63 deals with priorities between competing PMSIs. All PMSIs perfected under the rules in this section are subject to section 57 which deals with perfection by control.

Procedural requirements

There are two types of PMSI, collateral consisting of inventory and non-inventory. The procedural requirements for each are set out in s62.

Inventory

Notice requirement removed

Unlike Canada[36] there is no requirement for the secured party to give notice to other secured parties before advancing funds against inventory. The purpose behind the notice provisions in Canada is to warn existing secured parties that

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[36] Eg s34(3) Saskatchewan.

the PM secured party is going to provide funds to enable the debtor to increase his stock so that they will not make further advances against swelled stock in the belief that the debtor has enhanced his asset base. Normally an existing secured party would search before making a further advance to ensure that no purchase money security interests have been registered. Impractical for general security holder to search before each advance

By dispensing with the notice requirements, inventory financiers are treated in the same way as non-inventory financiers. Given its purpose it is difficult to see the rationale for removing the notice procedure.

In order to secure priority as PMSI in inventory or proceeds, the SP must perfect his security interest before debtor obtains possession of goods[37]. In the case of other collateral (intangibles), attachment is sufficient.

Third requirement

The third requirement is that the filing statement must contain a notation that the security interest claimed is a PMSI. The collateral must also be described by class in accordance with the regulations: s153 item 7. This means that a reference to collateral as inventory or equipment or goods is insufficient[38]

Cross-collateralisation

In practice, a purchase money security interest will normally arise between a financier and a single debtor as is the case with a debtor obtaining finance for a fleet of cars, trucks or computers or acquiring some specific item of equipment as a one off.

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[37] In a case where perfection is effected by possession by the SP, registration will not be required until possession is given to the debtor. The filing statement should be lodged before possession is given to the debtor.

[38] *Toronto Dominion Bank v Lanzarotta Wholesale Grocers Ltd* (1996) 12 PPSAC (2d) 30 (Ont CA).

A separate security agreement will be taken for each or a master agreement entered into with each drawdown being treated as a separate security agreement in respect of the new asset being acquired but under the umbrella of the master agreement.

It is sometimes the case that the security agreement for the new assets will be cross-collateralised to some existing security such as an equitable mortgage or debenture charge or even a prior PMSI from the same debtor.

The question that arises will the act of cross-collateralisation result in loss of the purchase money security status? To put it another way, does the existence of an all moneys security over all present and future property of the debtor, which covers future advances negate a purchase money security, if for example a loan was made to debtor to acquire 4 prime movers?

The loan to the debtor to acquire the 4 prime movers will give the secured party a purchase money security in the 4 prime movers provided that they are registered by serial numbers.

If a further loan is made to the debtor will it be secured by the 4 prime movers? The answer is no because the new loan was not made to acquire the trucks.

Taken a step further assume that the debtor then requires a further loan to acquire trailers for use with the prime movers and security provider takes a new PMSI security agreement in similar terms to the first PMSI security agreement for them which also extends to secure any other goods sold to the debtor.

The US courts have taken the view that the extension of the security agreement to other goods results in a *transformation* of the PMSI to a general security agreement with the result that the purchase moneys security priority is lost by virtue of the operation of the cross-collateralisation clause. These clauses were known as add-on security clauses in the US.

In *Re Manuel*[39] the court decided that automatic perfection of an add-on was inadequate where the collateral was insufficient to secure debt other than its own price.

In another case *Staley*[40] the court decided that the financier was saved by the presence of a first-in-first out provision in the security agreement. This provided for the PMSI in each item to terminate as soon as its purchase price was paid off.

Other courts have taken the *dual-status* approach resulting in the security being divided into purchase money and non-purchase money components. In the *John Deere* case[41], a debtor financed the balance of the purchase price of certain equipment under a security agreement that contained an after-acquired property clause and a future advances clause. The Court decided that a secured party can be a purchase money security financier even though the security agreement contained a cross-collateralisation clause, so long as the advance is actually used to acquire the goods over which a PMSI is claimed.

This position is now reflected in Article §9-103(f) which provides "In a transaction other than a consumer-goods transaction, a purchase money security interest does not lose its status as such, even if:

(1) the purchase-money collateral also secures an obligation that is not a purchase-money obligation;
(2) collateral that is not purchase-money collateral also secures the purchase-money obligation; or
(3) the purchase-money obligation has been renewed, refinanced, consolidated, or restructured."

The Bill seeks to deal with mixed securities in s14(3) and 14(4). This permits cross-collateralisation but reinforces the point that the PMSI is only security for

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[39] 507 F2d 990 (5th Cir 1975); 16 UCC Rep 493.
[40] 426 F Supp 437 (MD Ga 1977), 22 UCC Rep 799.
[41] 686 SW 2d 904; 309 UCC Rep 684 (Tenn) (1984).

the PMSI obligation. It reinforces the PMSI status and provides that non-PMSI obligations are not secured by the PMSI. But does not achieve what 9-103(f) seeks to do.

Consequence is that the PMSI retains its status for the PMSI outstandings only.

Renewals are dealt with in s14(5). This provisions effectively tracks 9-103(f)(3).

The Bill fails to state that the purchase money security interest does not lose its status and simply picks up §9-103(f)(2) by providing that the purchase money security interest (arising under s14(7)) under the mixed security agreement is only one to the extent that it secures purchase money obligations: s14(3).

The PMSI actually arise under s14(1) not s14(7).

Section 14(4) covers the additional point that it is only purchase money collateral that secures the purchase money obligation and any other collateral does not. The effect of this is that a financier cannot get extra security for the purchase money obligation that also enjoys the super priority status. The use of the words "to the extent" recognise that possibility that a security agreement can secure both purchase money and non-purchase money obligations[42].

Section 14(5) deals with renewals, etc and effectively picks up the full benefit of Article §9-103(f)(3) because it uses the same wording that "it does not lose its status" but it also adds on the words "(whether or not by the same secured party)". The words in parentheses should remove any doubts that might exist about the status of a PMSI that is refinanced through another lender or lenders in a consolidation.

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42 *In Re Billings* 838 F 2d 405 (10th Cir 1988). This case involved a new note and new security agreement. The court decided that the refinancing and renewal of the PMSI did not transform the PMSI into a non-PMSI.

Refinancing and consolidation

Section 14(6) deals with the application of moneys under a PMSI. This provision pick up the priority rule problems that the US and Canadian Courts have grappled with over the years with refinancing, debt consolidation and transfers. They provide the rules that apply where the security agreements fails to provide a contractual formula dealing with the how payments are to be apportioned between purchase money and non-purchase money components.

In the US some Courts traditionally used the *first in first out* rule[43]. In Canada in a case involving a consolidation of a purchase money security with a non-purchase money security the Court decided that the secured party had to prove the existence of the PMSI first and then prove that the debt was due in *Gerrard*[44].

The US Courts have also used the *pro rata* rule. This may be more appropriate in a consolidation of two separate obligations in a financing but the first in first out rule may be more appropriate in the case of a sale as in *Gerrard*.

In another case, *Battlefords*[45] the Court of Appeal took the easy way and decided that the purchase money secured party had a PMSI in all of the property that had been subject to the PMSI. It failed to look at how much was owed under each separate PMSI. The difficulty with the later approach is that the result would probably put the PMSI holder at an advantage vis-à-vis the general security holder because this approach effectively allows the PMSI holder to tack priority money on to the most valuable item of property in circumstances where there could be shortfall because the other PMSI debt had been reduced to a much smaller amount. This can be illustrated by the consolidation of two PMSIs.

Assume that $5,000 is owing under PMSI (1) securing a truck worth $25,000 and $12,000 is owed under PMSI (2) another truck worth $9,000. Debtor defaults

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[43] Eg *In Re Conn* 33 UCC Rep 701 (WD Ky 1982).

[44] *Re Gerrard* (2000) 20 CBR (4th) 90 (NSSC).

[45] *Battlefords Credit Union Ltd v Ilnicki* (1991) 82 DFLR (4th) 69 (Sask CA). See Duggan A, Hard Cases, Equity and the PPSA in 34 Can Bus L.J. 129 (2001).

and the goods are taken by the PMSI holder. The consolidated debt is $17,000. The PMSI secured party then says to general secured party that I am entitled to recover the $17,000 by resorting to both PMSIs. The effect of *Chrysler Credit Canada Ltd v Royal Bank of Canada*[46] decision is that the moneys can be tacked onto the other PSMI collateral.

Cuming, Walsh and Wood[47] say that this is wrong because the wording of the section refers "to the extent of". This means that the general security holder who registered first takes the excess from PMSI(1) because the balance of the sale proceeds after exhausting the PMSI are $20,000 less $5,000, which is not accorded PMSI status. The balance therefore goes to the general security holder.

The effect of the *Chrysler* decision has been reversed in s34(9) of the *Saskatchewan Personal Property Security Act* 1993. That section provides that a PMSI *in an item of collateral does not extend to or continue in the proceeds of an item after the obligation to pay the purchase price of the item or to repay the value for the purposes of enabling the debtor to acquire rights in it has been discharged.*

The result of this is that the prior general security holder picks up the equity in the collateral after repayment of the PMSI obligation because he is first in time.

There is no equivalent of this provision in the Bill.

Logically, this is a result but there is no certainty without an amendment to the Bill.

Section (6) provides a reallocation method based on Article 9-103(e) of Article 2001 Revision that attempts to resolve tension between the *first in first out* and the *pro rata* rules.

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[46] [1986] 6 WWR 338 (Sask CA).

[47] *Op cit* at p 345.

CONCEPT OF 'VALUE'

A secured party must have given value before a security interest attaches to collateral. The value must be real value. A cheque given as the value which is later dishonoured does not qualify[48].

Value is defined in s10 as 'consideration that is sufficient to support a contract' and 'includes an antecedent debt or liability'. This would include a promise to pay the purchase price, a forebearance to sue and a binding commitment[49] to give credit.

Section 10 also says that in relation to a PMSI has a meaning affected by section 14. Section 14(8) provides that value includes a reference to credit charges and interest payable for the purchase or loan credit. Section 14(8) does not seem to add anything to the definition of value *simpliciter* as it appears to go to the question of priority moneys.

At general law these items are part of the costs of getting your money back.

The Canadian cases say that value is given as soon as the secured party makes a binding commitment to extend credit to the debtor[50]. Cuming, Walsh and Wood suggest that the position is the same with a line of credit even if the debit balance was nil at any given time so long as the commitment has not been cancelled.

A security agreement under seal or executed as a deed qualifies as consideration under general contract law[51] although the definition of value only refers to consideration. This essentially because of the antecedent debt point which is overcome by deed at common law.

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[48] *Dale Tingely Chrysler Plymouth Ltd v Chris & Don Enterprises Ltd* (1994) 8 PPSAC (2d) 191.
[49] This is important because of the reimbursement point mentioned above in relation to the PMSI.
[50] See for example *Agricultural Credit Corp of Saskatchewan v Pettyjohn* (1991) 1 PPSAC (2d) 273 at 282 (CA).
[51] *Heidelberg Canada Graphic Equipment Ltd v Arthur Anderson Inc* (1993) 7 BLR (2d) 236.

Value includes an antecedent debt or liability thus enabling unsecured debt to be converted to secured debt.

It is thought that the inclusion of past consideration does away with the need to include words such as 'forbearance to sue' in the security agreement.

GOOD FAITH AND THE COMMERCIALLY REASONABLENESS

The Personal Property Securities legislation of New Zealand and Canada, including Article 9, impose an overriding obligation on a secured party to act in good faith and in a commercially reasonable manner in the exercise of its rights, duties, and obligations under a security agreement[52].

The New Zealand Act (s25) provides:

> (1) All rights, duties, or obligations that arise under a *security agreement or this Act* must be exercised or discharged in *good faith* and in accordance with *reasonable standards of commercial practice.*
>
> (2) A person does not act in bad faith merely because the person acts with knowledge of the interest of some other person.

The Saskatchewan Act (s65(3) and (4)) provides:

> (1) All rights, duties or obligations that arise pursuant to a *security agreement, this Act or any other applicable law* are to be exercised or discharged in good faith and in a *commercially reasonable manner.*
>
> (2) A person does not act in bad faith merely because the person acts with knowledge of the interest of some other person.

The approach in the Bill differs significantly and essentially picks up the Article 9 duty. The Bill (s111) provides:

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52 Eg S65(3) Saskatchewan, s 25 NZ

(3) *All rights, duties and obligations that arise under this Chapter*[53] must be exercised or discharged:

(a) *honestly*; and

(b) in a *commercially reasonable manner*.

(4) A person does not act dishonestly merely because the person acts with actual knowledge of the interest of some other person.

The principal significance of the duty to act in a commercially reasonable manner is to be found in the enforcement provisions of the North American legislation and in the New Zealand legislation. The Bill confines this duty only to the enforcement provisions in Chapter 4.

Subsection (4) deals with the priority issue but this is not necessary because the duty is limited to enforcement and does not include under the security agreement or under the Act as well or as in Saskatchewan under any applicable law.

The standard set by the duty has two aspects, namely, honesty and commercial reasonableness. Neither concept is defined and no guidance is given as to what good faith or honestly mean in this context. Neither good faith nor honesty is defined in the Canadian legislation.

Article 9 itself does not defined good faith but the definition is to be found in UCC §1-201(20). It is defined to mean "honesty in fact and the observance of reasonable commercial standards of fair dealing".

Where does this leave us for guidance?

It is thought that the answer lies in the *Bills of Exchange Act 1909*. "A thing is deemed to be done in good faith, within the meaning of this Act, where it is in fact done honestly whether it is done negligently or not": s96. So far so good. What then does honestly mean? It would seem that mere negligence, however gross, not amounting to wilful fraud or fraudulent blindness and abstinence from inquiry, will not of itself amount to lack of honestly or bad faith[54]. In *Jones v*

[53] Chapter 4. This chapter deals with the enforcement of security interests.

[54] Goodman v Harvey (1836) 4 A & E 870

Gordon[55], Lord Blackburn was of the view that honest blundering and carelessness were not dishonesty but a dishonest refraining from inquiry was dishonesty.

The words 'whether it is done negligently or not' are absence from the section[56]. The fact that one has actual knowledge seems to operate in much the same way as the fraud element in relation to the Torrens system, notice is not fraud nor is notice bad faith or a failure to act honestly.

Gilmore[57] says that the "secured party's overriding obligation is to act (as the Code puts it) in a 'commercially reasonable' manner, or (as judge Desmond put in *Kaimie*[58]), 'in good faith', or (as Judge Learned Hand, citing *Kiamie*, once put it) with a 'reasonable regard for the pledgor's right' ".

The test therefore seems to be whether the person acted with honest intent. This is a subjective test demanding honesty in fact which is borne out by Lord Blackburn's view and the use of the word 'honestly'. This view is supported also by the words that 'a person does not act in bad faith because the person acts with knowledge of the interest of another person' in s111(2).

The mode of conduct set by the use of the words 'in a commercial reasonable manner' seems to focus on the market practices of a secured party. This translates to the observance of commercial standards of fair dealing.

The difficulty with the duty in s111 is the ability of a secured party to contract out of the certain enforcement provisions (s115) other than s111. Also Chapter 4 does not apply to property while under the control of a receiver or receiver and manager or a controller (s116). This is an odd provision and probably renders the duty nugatory given the receiver will undoubtedly be exercising the rights and remedies that the secured party has and will be realising the assets of the debtor under the security agreement as agent for the debtor. This should not

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55 (1877) 2 App Cas 616 at 828-629.

56 According to Riley's Bill of Exchange 3ed at p232, section 96 of the Bills of Exchange Act is founded on this distinction.

57 Security Interests in Personal Property (1965) vol 2, p1234.

58 *In re Kiamie's Estate* 309 NY 325, 330, 130 NE 2ed 745, 747 (1955).

make a difference. The duty is further undermined if the obligations are secured over both personal property and land as a secured party may exercise the higher priority security under s117 and apply the law relating to land law decisions under s118(3).

Section 101 *Property Law Act 1958* (Vic) and s109(1) of the NSW Conveyancing Act (NSW) deal with the mortgagee's power of sale and set out the powers where the mortgage is by deed and empowers the mortgagee to sell in the manner provided as it thinks fit. Those powers are all that a mortgagee gets. Section 103 sets the requirement for notice before the power of sale becomes exercisable. Section 106(3) provides that the mortgagee is not responsible for involuntary loss.

The Transfer of Land Act (Vic) s77(1) uses the words 'in good faith' and having regard to the interests of the mortgagor or other persons. These words have not entertained much judicial comment but for *Henry Roach*[59] and most recently in *Nolan v MBF Investments Pty Ltd* [2009] VSC 244 (18 June 2009) where Vickery J put a gloss on the interests of the mortgagor because of the Human Rights Act (Vic).

General law duty in Australia

The good faith standard in *Pendlebury*[60] seems to represent the common law standard of care for a mortgagee in Australia and may be stated as imposing an obligation on a mortgagee to exercise his power of sale in good faith having regard to the interests of the mortgagee but not disregarding the interests of the mortgagor[61].

Croft and Johannsson[62] summarise the following matters as part of the mortgagee's duty:

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59 *Henry Roach (Petroleum) Pty Ltd v Credit House (Vic) Pty Ltd* [1976] VR 309.
60 *Pendelbury v Colonial Mutual Life Assurance Society Ltd* (1912) 13 CLR 676.
61 Croft and Johannsson *The Mortgagee's Power of Sale* 2ed (2004) at 145.
62 *Op cit* at 144-145.

1. the mortgagee is not a trustee.
2. a mortgagee is entitled to realise his security by selling the collateral as and when he chooses (subject to any notice requirement) except where the timing would cause manifest unfairness.
3. Power to be exercised in good faith taking into account the mortgagees interest but not ignoring those of the mortgagor.
4. Mortgagee is bound to obtainable the best price obtainable.
5. The mortgagee owes no duty that would make it liable for mere negligence or carelessness. The position appears to be different in New Zealand as a certain degree of negligence or carelessness might put the mortgagee in breach of it duty to obtain the best price.
6. The duties in relation to land registered land (Torrens title) are generally the same in relation to general law land. It is clear that the common law duty also extends to personal property and where the powers of sale is being exercised by a receiver the duty is owed to the creditors generally[63].

Obtaining a proper or fair price or fair market value of the property being sold is simply part of the duty to act in good faith. In *Latec Investments Ltd v Hotel Terrigal Pty Ltd*[64] Kitto J though that the mortgagee's duty of good faith was satisfied if the mortgagee took reasonable steps to obtain a fair value on sale.

In Canada, the general duty seems to be to take reasonable care to obtain the true market value[65]. True market value and proper price[66] seem to be one and the same thing[67].

In *Forsyth v Blundell* Menzies J said[68]:

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[63] *Expo International Pty Ltd v Chant* [1979] 2 NSWLR 820.

[64] (1965) 113 CLR 265 at 273.

[65] *McHugh v Union Bank of Canada* [1913] AC 299 PC.

[66] Cf *Goldcel Nominees Pty Ltd v Network Finance Ltd* [983] 2 VR 257 where Murphy J thought that the statutory duty was to obtain the best price at 261-262.

[67] *Cuckmere Brick Co Ltd v Mutual Finance* [1971] Ch 949 Salmon LJ at 968. *Cuckmere* seems to have been accepted as the law in New Zealand by the Privy council in *Downsview Nominees Ltd v First City Corporation* [1993] AC 295 (as case dealing with receivers) but there is no negligence standard involved.

[68] *Forsyth v Blundell* [1973] HCA 20; (1973) 129 CLR 477 at 481.

"The rule to be applied here is not in doubt; it was stated authoritatively by Lord Herschell in the last century. In *Kennedy v de Trafford* (1897) AC 180, which has been followed by this Court in *Barns v Queensland National Bank Ltd* (1906) 3 CLR 945 and *Pendlebury v Colonial Mutual Life Assurance Society Ltd* [1912] HCA 9; (1912) 13 CLR 676, the Lord Chancellor said (1897) AC, at p185 :

"... if a mortgagee in exercising his power of sale exercises it in good faith, without any intention of dealing unfairly by his mortgagor, it would be very difficult indeed, if not impossible, to establish that he had been guilty of any breach of duty towards the mortgagor. Lindley LJ in the Court below, says that 'it is not right or proper or legal for him either fraudulently or wilfully or recklessly to sacrifice the property of the mortgagor.' Well, I think that is all covered really by his exercising the power committed to him in good faith. It is very difficult to define exhaustively all that would be included in the words 'good faith', but I think it would be unreasonable to require the mortgagee to do more than exercise his power of sale in that fashion. Of course, if he wilfully and recklessly deals with the property in such a manner that the interests of the mortgagor are sacrificed, I should say that he had not been exercising his power of sale in good faith".

I do not think that statements in some cases, such as *McHugh v Union Bank of Canada* (1913) AC 299 or *Cuckmere Brick Co Ltd v Mutual Finance Ltd* (1971) Ch 949, that the mortgagee is under a duty to take reasonable precautions to obtain a proper price, are at odds with the rule stated by Lord Herschell. *To take reasonable precautions to obtain a proper price is but a part of the duty to act in good faith.* This duty to act in good faith falls far short of the Golden Rule and permits a mortgagee to sell mortgaged property on terms which, as a shrewd property owner, he would be likely to refuse if the property were his own.

Matters that the Canadian and US courts take into account in determining whether a secured party has acted in a commercially reasonable manner include:

1. Preparing the collateral for disposition by repair: *Donnelly v International Harvester Credit Corp of Canada* (1983) 2 PPSAC 290;
2. Selling by public auction or tender or private sale;
3. Purchase of the property by the secured party only if the sale is by public auction or tender and only if the price bears a reasonable relationship to its market value.

There are a number of other factors and these as listed in Cuming Wood and Gedye.

Commercial reasonableness unlike good faith seems dependent on an understanding of what is considered reasonable by those involved in a particular industry or practice under scrutiny as opposed to a subjective understanding of a particular person whose conduct is in issue.

Guidance on this comes from Article 9 §9-627(6) which refers to:

(1) in the usual manner in any recognised market;
(2) at the price current in any recognised market at the time of sale (eg Red Book value for motor vehicles);
(3) otherwise in conformity with reasonable commercial practices among dealers in the type of property that was subject of the sale.

On balance commercial reasonableness seems to be something higher than good faith or honesty. Good faith equates to honesty but the sale must be in a commercially reasonable manner. Gilmore[69] suggests that this imposes an obligation to use every effort to sell under every possible advantage of time, place and publicity.

Consumer practices would seem to dictate that price is probably more important after compliance with the Uniform Credit Code. But in commercial matters correct procedures are probably more important as market conditions will dictate price more than anything else.

It is probably fair to say that the obligation to act in good faith or honestly in a commercially reasonable manner is a higher burden than that imposed on a mortgagee at general law and also by statute in relation to land.

The Bill's proposals in Chapter 4 that allow a secured party to use the land procedures where mixed collateral is involved will create problems. It is unreasonable to expect a secured party to have to follow two differing standards

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[69] *Op cit*, Vol 2, 1233-1234.

depending on whether the collateral is land or personal property, or if mixed choose the land procedures if the priority is higher. It is assumed that priority means first in time rather than value but it is more likely the draftsman meant value.

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