

Romalpa Agreements

Post-PPSA

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Abstract

Based in part on Article 9 of the United States Uniform Commercial Code and comparable Canadian provincial laws, the *Personal Property Securities Act 2009* (Cth) ('PPSA') is a wholesale reform of the law governing secured transactions in personal property and it represents a major step in the development of Australian commercial law. The PPSA is a novel and complex statute, but criticisms of its complexity tend to overlook the complexity of the laws it replaces. Closer familiarity with the PPSA brings with it the realisation that, in numerous significant respects, the statute simplifies the law. The aim of this article is to demonstrate the point by examining the PPSA's treatment of *Romalpa* agreements with particular reference to how the PPSA approach differs from, and improves on, the previous law. The article also identifies some key differences between the relevant provisions in the Australian PPSA, Article 9, the Canadian PPSAs and the *Personal Property Securities Act 1999* (NZ).

I Introduction

A *Romalpa* clause is a provision in a contract for the sale of goods on credit terms specifying that title to the goods will remain with the seller until the buyer has paid the price or met some other requirement. The name derives from the landmark English case, *Aluminium Industrie Vaassen BV v Romalpa Aluminium Ltd.*¹ *Romalpa* clauses are also known as 'reservation of title clauses'. Agreements subject to these provisions are sometimes referred to as 'conditional sale agreements', though this usage is more common in Canada and the United States than it has been, up until now, in

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¹ [1976] 1 WLR 676.

Australia and other Commonwealth countries.² The new *Personal Property Securities Act 2009* (Cth) ('PPSA'), in s 12(2)(d), uses the expression 'conditional sale agreement' but muddies the waters somewhat by adding parenthetically that a conditional sale agreement 'includes an agreement to sell subject to retention of title'.³

Pre-PPSA, a *Romalpa* clause might take different forms, depending on the nature of the goods and how the buyer intended to use them.⁴ In its most basic form, the provision simply reserves title in the goods supplied until the buyer has paid for them. But various bells and whistles may be added, such as an all liabilities clause specifying that the seller reserves title until the buyer has paid all amounts owing to the seller on any account. If the seller knows the buyer intends the goods for resale, the clause may contain an additional provision asserting title to the sale proceeds in the buyer's hands. Or if the goods are raw materials and the seller knows the buyer intends to use them in a manufacturing process, the clause may assert a claim to the end product.

Pre-PPSA, assuming the buyer to be a company, it was important to know whether these kinds of arrangements were registrable in the register of company charges established by Chapter 2K of the *Corporations Act 2001* (Cth). The most basic form of *Romalpa* agreement was clearly not registrable because the company charges registration scheme, as its name suggests, only applied to charges and mortgages. In other words, the scheme was limited to security interests in the traditionally understood sense: 'an interest 'granted' by the debtor to his creditor over assets the debtor already owns or will own'.⁵ A *Romalpa* agreement is not a security agreement in this sense because the seller's claim to the goods depends not on any grant by the buyer but, rather, on the seller retaining title to goods it has owned all along.⁶ Given the non-application of the company charges registration provisions, the seller's interest in the goods, relative to the claims of other creditors, remained subject to basic common law principles. The main implications were twofold. First, if the buyer became insolvent, the seller could reclaim the goods from the insolvency administrator on the ground that the goods belonged to the seller, not the buyer, and so they were not part of the estate. Second, if the buyer had created a floating charge in a third party's favour then, if

² Gerard McCormack, *Secured Credit under English and American Law* (Cambridge University Press, 2004), 163–4.

³ Emphasis added.

⁴ Hugh Beale et al, *The Law of Personal Property Security* (Oxford University Press, 2007), [5.07]. See also Bruce Whittaker, 'Retention of Title Clauses Under the Personal Property Securities Act 2009 (Cth)' (2010) 21 *Journal of Banking and Finance Law and Practice* 273–4.

⁵ Beale et al, above n 4 [5.03].

⁶ *Ibid.*

the buyer defaulted, the seller could claim the goods ahead of the charge on the ground that the goods were not the buyer's property and so they fell outside the scope of the floating charge.⁷

But the position was different where the clause, in addition to reserving title in the goods themselves, also staked a claim to their sale proceeds or to the end product of a manufacturing process in which the goods were raw materials or components. In these cases, the courts were likely to construe the super-added claim as a charge over the asset in question and therefore subject to registration under the *Corporations Act*.⁸ Again, the main implications were twofold. First, if the buyer became insolvent and the seller had failed to register within the prescribed time limits, the charge was void against the insolvency administrator and the seller was in effect relegated to the status of an unsecured creditor.⁹ Second, if the buyer had created a competing charge over the same collateral in favour of a third party creditor, the competing charge typically had priority over the seller's claim if the seller failed to register.¹⁰ In any event, even if the seller did register its charge, there was still the risk of subordination to a prior registered charge on the same collateral.¹¹

To summarise, in the case of a basic *Romalpa* provision, pre-PPSA law strongly favoured the *Romalpa* supplier over the buyer's other creditors, but in the case of extended *Romalpa* provisions, the advantage was the other way round. These outcomes were largely driven by formal considerations — in particular, the distinction between transfer and title retention transactions enshrined in the *Corporations Act* registration provisions. The PPSA rings three main changes: first, it somewhat strengthens the position of other creditors

⁷ See Brendan Brown and John Sampson, 'Retention of Title under New Zealand's Personal Property Securities Act 1999' [2002] *Journal of International Banking Law* 102, 102–3.

⁸ For an overview of the English cases, see Beale et al, above n 4, [5.07]–[5.25]; McCormack, above n 2.; Louise Gullifer (ed), *Goode on Legal Problems of Credit and Security* (Sweet & Maxwell 4th ed, 2008), [1-28] – [1-32]. For a fuller treatment, see Gerard McCormack, *Reservation of Title* (Sweet & Maxwell, 2nd ed, 1995). For an Australian account, see Berna Collier, *Romalpa Clauses: Reservation of Title in Sale of Goods Transactions* (Law Book Co, 1989). For a fuller list of references, see R P Austin and I M Ramsay, *Ford's Principles of Corporations Law* (LexisNexis, 14th ed, 2010), [28.240].

⁹ See *Corporations Act 2001* (Cth) s 266 which provided that a registrable charge was void against the company's insolvency administrator unless it was registered: (1) within 45 days after the creation of the charge; or (2) at least 6 months before the commencement of the insolvency proceedings.

¹⁰ *Ibid* ss 280 and 281.

¹¹ *Ibid*. If the prior registered charge was a floating charge, it would not have priority over the seller unless there was a provision in the floating charge agreement forbidding the creation of the seller's charge and notice of the provision was lodged with the registrar before creation of the seller's charge: *ibid.* s 279. To put the point the other way round, the holder of the floating charge could secure priority for itself by complying with the s 279 requirements.

relative to the seller in relation to the goods the seller supplies;¹² second, it strengthens the seller's position relative to other creditors in relation to proceeds claims and the like; and third, it substitutes a policy-driven approach to priority disputes involving *Romalpa* agreements for the formalism that was a hallmark of the old law. In the process, it achieves substantial savings on litigation costs by avoiding the question that dominated the pre-PPSA case law, namely whether a particular transaction does or does not amount to a charge for registration purposes. The main features of the PPSA's approach to reservation of title arrangements are as follows:

1. the statute applies to every transaction, regardless of form, that in substance creates a security interest including both transfer and title retention arrangements and, specifically, 'a conditional sale agreement (including an agreement to sell subject to retention of title)';¹³
2. the PPSA establishes a registration system for personal property security interests which, in contrast to the *Corporations Act* system, applies to all entitlements that are in substance security interests without regard to the form of the transaction that governs the entitlement;¹⁴
3. the statute provides for perfection of security interests by various methods including, most importantly, registration and it relegates the holder of an unperfected security interest to unsecured creditor status if the debtor ('grantor'¹⁵) becomes subject to insolvency proceedings (bankruptcy, winding-up or voluntary administration);¹⁶
4. the statute also provides that an unperfected security interest is subordinate to a competing perfected security interest in the same collateral and that, in a competition between security interests perfected by registration, as a general rule, the first registered security interest has priority;¹⁷
5. by way of exception to the first to register priority rule, the statute gives super-priority status to *Romalpa* agreements and other so-called 'purchase-money security interests' ('pmsis') subject to certain conditions, the result being to give a pmsi priority over a

¹² By: (1) imposing registration requirements on the seller as a condition of priority; and (2) limiting the reach of all liability clauses: see further, Part II, below.

¹³ PPSA s 12.

¹⁴ Ibid ch 5. For details, see Anthony Duggan, 'A PPSA Registration Primer' (2011) 35 *Melbourne University Law Review* (forthcoming).

¹⁵ 'Grantor' is the expression the Australian PPSA uses to describe the party who grants the security interest: *ibid* s 10.

¹⁶ *Ibid* s 267.

¹⁷ *Ibid* s 55.

- competing non-pmsi security interest without regard to the order of registration;¹⁸
6. the statute extends the pmsi's super-priority status to cover proceeds resulting from a sale or other dealing in the collateral, the result being to give the pmsi holder priority, subject to certain conditions, over competing claims to the money or other consideration the buyer has received in exchange for the original goods;¹⁹
 7. the statute enacts special rules for raw materials and other manufacturing inputs ('commingled goods'), specifying that the input seller's security interest continues in the end product and addressing competing claims to the end product;²⁰
 8. similarly, the statute enacts special rules for component parts and the like ('accessions'), specifying that the component seller's security interest continues following incorporation of the component into the host goods and addressing competing claims to the component between the component seller and the owner of the host goods.²¹

The following discussion addresses these points in more detail, with particular reference to differences between the PPSA and the pre-PPSA law governing *Romalpa* agreements and also to some key differences between the pmsi provisions in the Australian PPSA, the New Zealand PPSA and the Canadian provincial PPSAs.²² Part II, below, starts with the simple case of a dispute between the seller (pmsi-holder) and a third party claimant over the goods the seller supplied. Part III addresses the case where the buyer (grantor) has resold the goods and the seller is in dispute with a third party over the sale proceeds. Part IV deals with disputes involving accessions and commingled goods. Part V concludes.

¹⁸ Ibid s 62. 'Purchase-money security interest' is defined in s 14: see further Part II, below.

¹⁹ Ibid s 62.

²⁰ Ibid pt 3.4.

²¹ Ibid pt 3.3.

²² *Personal Property Securities Act 1999* (NZ); *Personal Property Security Act* RSA 2000, c P-7 ('Alberta PPSA'); *Personal Property Security Act* RSBC 1996, c 359 ('British Columbia PPSA'); *Personal Property Security Act*, CCSM c P35 ('Manitoba PPSA'); *Personal Property Security Act* SNB 1993, c P-71 (New Brunswick PPSA); *Personal Property Security Act* SNL 1998, c P-7.1 ('Newfoundland and Labrador PPSA'); *Personal Property Security Act* SNWT 1994, c 8 ('Northwest Territories PPSA'); *Personal Property Security Act* SNS 1995-96, c 13 ('Nova Scotia PPSA'); *Personal Property Security Act* SNWT 1994, c 8 ('Nunavut PPSA'); *Personal Property Security Act*, RSO 1990, c P-10 ('Ontario PPSA'); *Personal Property Security Act* RSPEI 1988, c P-3.1 ('Prince Edward Island PPSA'); *Personal Property Security Act* 1993, SS 1993, c P-62 ('Saskatchewan PPSA'); *Personal Property Security Act* RSY 2002, c 169 ('Yukon PPSA').

II Competing Claims to the Goods Themselves

A Introduction

Example 1. On Day 1, pre-PPSA, Company gives SP1 a floating charge over all its present and after-acquired property and the floating charge is duly registered in the register of company charges. On Day 10, SP2 sells and delivers a printing press to Company, for use in Company's publishing business. The sale is on reservation of title terms. On Day 50, Company defaults against SP1 and SP2 and they both claim the press.

Although SP1's floating charge is a registrable charge for the purposes of the *Corporations Act*, SP2's interest in the press is not because the *Corporations Act* provisions do not apply to title retention arrangements.²³ Therefore, the *Corporations Act* priority rules do not apply and the common law governs instead. At common law, SP2's claim prevails over SP1's for the simple reason that SP1's floating charge is limited to Company's property and the press belongs to SP2, not Company.²⁴

Example 2. On Day 1, post-PPSA, Company gives SP1 a security interest in all its present and after-acquired personal property and registers a financing statement in the PPS register. On Day 10, SP2 sells and delivers a printing press to Company, for use in Company's publishing business. The sale is on reservation of title terms. On Day 50, Company defaults against SP1 and SP2 and they both claim the press.

SP1's and SP2's claims are both subject to the PPSA; the PPSA applies to SP1's claim because it is in both form and substance a security interest and it applies to SP2's claim because it is in substance a security interest regardless of its form.²⁵ For the purposes of the statute, SP2 is deemed to have transferred ownership of the press to Company on Day 10 but to have taken or retained a security interest to secure payment of the sale price. On this basis, the press is Company's 'property' and so it is subject to SP1's security interest.²⁶ In summary, SP1 and SP2 both have claims to the press and the PPSA priority rules

²³ See notes 6 and 7, above.

²⁴ See Brown and Sampson, above n 7. For a critical account of the common law approach to purchase money security interests at large, see Gullifer (ed), *Goode on Legal Problems of Credit and Security* above n 8, [5-62]–[5-64].

²⁵ PPSA s 12.

²⁶ See PPSA s 19(2) which provides, in part, that to create an enforceable security interest, the grantor must have rights in the collateral and s 19(5) which provides that, for the purposes of s 19(2), where goods are sold to a grantor on conditional sale terms, the grantor is deemed to have rights in the goods when she obtains possession.

apply to determine the dispute.²⁷ SP2's security interest is a pmsi within the meaning of the statute: 'a security interest taken in collateral [to secure] all or part of its purchase price'.²⁸ It follows that the special priority rules for pmsis apply (PPSA, s 62). Section 62 gives priority to a pmsi over a competing non-pmsi security interest subject to two conditions: (1) the pmsi-holder must register a financing statement; and (2) the financing statement must disclose that the security interest is a pmsi. If the disputed collateral is inventory, the financing statement must be registered before the inventory is delivered, but otherwise the financing statement may be registered any time up to 15 business days after delivery. In Example 2, the printing press is not inventory because it is not part of Company's stock-in-trade,²⁹ and so the more liberal registration requirement applies. The upshot is that SP2 has priority over SP1 provided that it registers a financing statement within 15 business days after Day 10. Comparing the discussion of Examples 1 and 2, it will be evident that the pre-PPSA and PPSA outcomes are almost the same, except that the PPSA imposes a registration requirement on SP2 as a condition of super-priority. Likewise in a case where the seller's dispute is with the buyer's liquidator, trustee in bankruptcy or insolvency administrator: pre-PPSA, the seller could reclaim the goods on the ground that they did not belong to the buyer and so were not part of the estate. Post-PPSA, the seller may reclaim the goods but only if it registers a financing statement within the required time limits.³⁰

²⁷ Subject to the proviso that SP2's security agreement must be in writing. PPSA s 20 provides that, *as a general rule*, a security agreement must be evidenced by writing, it must contain a description of the collateral and it must be signed by the grantor or, alternatively, adopted or accepted by the grantor by an act or omission that reasonably appears to be done with the intention of adopting or accepting the writing. The adoption or acceptance alternative is designed to accommodate long-standing contracting practices; *Romalpa* suppliers commonly do not require the customer's signature. Instead, the supplier will send a prospective customer a copy of its trading terms, including the retention of title provision, with the stipulation that any subsequent supplies to the customer will be made on those terms: see Brown and Sampson, above n 7, 103. By ordering the goods, the customer 'adopts or accepts' the written terms for the purposes of PPSA s 20. Failure to comply with s 20 means that the security agreement is unenforceable against third parties.

²⁸ PPSA s14(1)(a). See further, Part II C, below.

²⁹ See PPSA s 10 (definition of 'inventory').

³⁰ Unless the buyer is a company, it is sufficient if the seller's security interest is registered at the commencement of the insolvency proceedings: PPSA s 267. If the buyer is a company, the seller must register at least six months before the commencement of the insolvency proceedings or 20 business days after the security agreement became enforceable: *Corporations Act 2001* (Cth) s 588FL. This provision was inserted into the *Corporations Act* by the *Personal Property Securities (Corporations and Other Amendments) Act 2010* (Cth) and it replaces *Corporations Act 2001* (Cth), s 266. There are some differences between old s 266 and new s 588FL. The most important is that the old provision was limited to company charges and it did not apply to title retention arrangements. The new provision applies to all 'PPSA security interests', including title retention arrangements: see Commonwealth of Australia, House of Representatives, *Explanatory Memorandum*

B Policy Considerations

In a competition between security interests in the same collateral, pre-PPSA law normally took a ‘first in time’ approach and the PPSA by and large continues this tradition. The justification for some version of the first in time rule is obvious: under any other approach, a secured party would have no way of knowing at the time of transacting whether its security interest would end up being worth anything and this uncertainty would undermine the practice of secured lending. Why, then, does the PPSA abandon the first in time rule when it comes to pmsis? There are two main policy justifications, represented by the so-called new money theory and the situational monopoly theory.

A pmsi-holder (SP2) adds new money to the debtor’s (grantor’s) enterprise in the sense that it allows the debtor to acquire new assets, typically inventory or equipment, for use in the business. There are two versions of the new money theory, a dynamic version and a static version.³¹ According to the dynamic version, SP2 deserves priority because the new assets increase the debtor’s profitability: new equipment improves the efficiency of the enterprise and new inventory allows for additional sales. Increased profitability reduces the risk of the debtor’s defaulting on its payment obligations and, in this sense, SP2’s new money potentially makes the competing secured lender (SP1) better off. According to the static version of the new money theory, SP2 deserves priority because even if its new money does not make SP1 any better off, at least SP1 is no worse off. The reason is that each new dollar of debt the debtor incurs to SP2 is exactly offset by a new dollar of asset value so that SP2’s security interest does not diminish the debtor’s asset base. In other words, giving SP2 priority for the collateral in question puts SP1 in no worse position than if the debtor had not contracted with SP2 in the first place. For these reasons, SP1 will at best favour, and at worst be indifferent to, ceding priority to SP2 and so a statutory rule in SP2’s favour simply reflects the outcome the parties would have bargained for anyway. The advantage of a statutory rule is that it avoids the need for express contractual provisions to deal with the matter.³²

on the Personal Property Securities (Corporations and Other Amendments) Bill 2010 (Cth), [6.1]–[6.13].

³¹ For a fuller account and criticism of the new money theory, see Alan Schwartz, ‘A Theory of Loan Priorities’ (1989) 18 *Journal of Legal Studies* 209.

³² All the PPSA priority rules are default rules, in the sense that the parties are free to contract for a different priority ordering via a subordination agreement: PPSA s.61. One implication is that, if in any case, the PPSA pmsi priority rules do not reflect the parties’ desired outcome, the parties may contract for a different priority ordering.

The situational monopoly theory runs as follows.³³ Aside from the pmsi provisions, the PPSA strongly favours the first in time creditor and this gives SP1 a potential monopoly over the debtor's present and future borrowing requirements. For one thing, the statute allows SP1 to take a security interest in all the debtor's present and after-acquired personal property and to obtain priority for it by registering ahead of anyone else.³⁴ If SP1 takes advantage of this facility, there will be no collateral left for other creditors to take a first-ranking security interest. In summary, the statute enables SP1 to lock up all the debtor's collateral. For another thing, the statute allows SP1 to make future advances and it gives SP1 the same priority for future advances as for the original loan.³⁵ If SP1 has taken a security interest in all the debtor's present and after-acquired personal property and is the first to register, a provision for future advances in SP1's loan contract locks up all the debtor's borrowing requirements. Example 3 illustrates the concern.

Example 3. SP1 takes a security interest in all Company's present and after-acquired personal property and registers a financing statement on Day 1. SP1 and Company's agreement provides for the making of future advances. On Day 2, SP1 lends Company \$100. On Day 3, Company negotiates with SP2 for a secured loan of \$50. SP2 does a register search and discovers SP1's security interest. Having done this, SP2 realises it cannot obtain a first ranking security interest in any of Company's collateral for the \$50 loan.

What are SP2's options in these circumstances? One possibility might be to negotiate a subordination agreement with SP1 but, failing this, SP2 will have to be content with a second-ranking security interest behind SP1. However, a second-ranking security interest may not offer the same level of protection and so SP2 will likely raise its interest charges to compensate for the added risk. The problem is that, by raising its interest charges, SP2 makes itself less competitive with SP1 and so, other things being equal, Company will borrow the \$50 from SP1 instead, because SP1's terms are better. In summary, according to the situational monopoly theory, the purpose of the pmsi super-priority rules is to counteract SP1's monopoly advantage and to facilitate borrowing from other sources.

³³ See Thomas H Jackson and Anthony T Kronman, 'Secured Financing and Priorities Among Creditors' (1979) 88 *Yale Law Journal* 1143.

³⁴ PPSA ss 55, 160.

³⁵ PPSA ss 18(4), 58.

C The Meaning of 'Purchase Money Security Interest'

(a) Seller pmsis and Lender pmsis

The PPSA s 14(1) defines 'purchase money security interest', in relevant part, as follows:

'A purchase money security interest means any of the following:

(a) a security interest taken in collateral, 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'.

Paragraph (a) is aimed at the case where a seller takes a security interest in goods it sells to the buyer to secure payment of the purchase price. In the case of a *Romalpa* agreement, formally speaking the seller does not 'take a security interest'; it reserves title. However, s 14 must be read in conjunction with s 12 which, for the purposes of the statute, in effect assimilates title reservation arrangements with security interests in the strict sense. It follows that the seller's interest under a *Romalpa* agreement is a pmsi in the s 14(1)(a) sense.

The transaction s 14(1)(a) refers to is a two-party one, involving a seller and a buyer. Paragraph (b) deals with the equivalent three-party transaction, where a lender lends money to a buyer to finance a purchase from the seller and the lender takes a security interest in the goods purchased to secure repayment of the loan. A pmsi falling under paragraph (a) of the definition is commonly referred to as a 'seller's pmsi', while a pmsi that falls under paragraph (b) is known as a 'lender's pmsi'.³⁶ One element of the paragraph (b) definition is that the loan must be for the purpose of enabling the grantor (buyer) to acquire rights in the collateral (goods). This makes the chronology important: if the contract of sale precedes the loan agreement, the lender's security interest typically will not be a pmsi. The reason is that property passes to the buyer under the contract of sale, and if the buyer already owns the goods at the time the seller agrees to make the loan, the loan cannot be 'for the purpose of enabling the [buyer] to acquire rights in the collateral'.³⁷ The other main element of the paragraph (b)

³⁶ See eg, Ronald CC Cuming, Catherine Walsh and Roderick J Wood, *Personal Property Security Law* (Irwin Law, 2005) 331.

³⁷ *North Platte State Bank v Production Credit Association of North Platte* 200 NW 2d 1 (Neb, 1972) ('*North Platte*'). In *North Platte*, the buyer bought the goods from the seller on unsecured credit terms and subsequently took a loan from the lender to pay the seller. The court held that the lender did not have a pmsi. Cf *Agricultural Credit*

definition is that the buyer (grantor) must apply the value received to acquire ownership.

Example 4. SP1 has a security interest, perfected by registration on Day 1, in all Company's present and after-acquired personal property. SP2 lends Company money to purchase a herd of cattle from Seller and takes a security interest in the cattle to secure repayment. SP2 registers a financing statement on Day 2. As events turn out, Company draws on an alternative source of funds to pay for the cattle and uses SP2's money for another purpose.

SP2 has a security interest in the cattle, but it is not a pmsi because Company did not apply the value SP2 provided to buy the cattle. The result is that, in a priority dispute between SP1 and SP2, SP2 does not have the benefit of the pmsi super-priority rule and the first to register rule in PPSA, s 55 applies instead. SP2 could have avoided this outcome by paying the loan proceeds directly to Seller.

(b) The Sale and Leaseback Exception

The PPSA s 14(2) lists a number of exceptions to the definition in s 14(1), including 'an interest acquired under a transaction of sale and lease back to the seller'.

Example 5: Company runs a publishing business and its assets include a number of printing presses. Company sells one of the presses to SP who, in turn, leases the press back to Company for a three year term.

SP's lease gives it a security interest in the press for the purposes of the statute (PPSA s 12), but the security interest is not a pmsi because it falls under the s 14(2) exception. The exception is most easily explained in terms of the new money theory: Company's deal with SP does not bring new money into Company's enterprise. It is true that Company now has some extra cash, but this value is offset by Company's loss of title to the press. In substance, the case is the same as if Company had simply borrowed money from SP, using the press or some other existing asset, to secure repayment. Assume that, in Example 5, instead of leasing the press back to Company, SP resells it

Corp of Saskatchewan v Pettyjohn (1991) 79 DLR (4th) 22 (Saskatchewan Court of Appeal), where the buyer arranged a bank loan to finance the purchase and, when there was a delay in the loan funds coming through, obtained interim finance to pay the seller. Upon receipt of the loan funds, the buyer used them to repay the interim financier. The court held that the bank had a pmsi; in contrast to *North Platte*, the buyer had applied for the bank loan before making the purchase and, on this basis, the interim finance arrangement and the bank loan were in substance two stages in one overall transaction: (1) the interim financier loaned the buyer money to enable the buyer to acquire the collateral; and (2) the bank loaned the buyer the money to repay the interim financier. Therefore, indirectly, the bank's loan enabled the buyer to acquire the collateral.

to Company on *Romalpa* terms. The s 14(2) exception does not apply because it is limited to sale and lease-back arrangements. However, in Canada the courts have held that, by implication, a sale and re-purchase agreement does not create a pmsi.³⁸

(c) *Mixed pmsis and Non-pmsis*

Sections 14(3) and (4) deal with mixed pmsis and non-pmsis and they are relevant to the inclusion of all liability and cross-collateralisation clauses in *Romalpa* agreements. The provisions are borrowed from Article 9 of the United States Uniform Commercial Code.³⁹ There are no corresponding provisions in any of the Canadian PPSAs, but the courts have read into the statute rules to similar effect.⁴⁰

Section 14(3) provides, in effect, that a security interest does not lose its pmsi status simply because the purchase money collateral also secures a non-purchase money obligation.

Example 6. SP supplies Company with motor vehicle spare parts for resale in Company's dealership business. There is a provision in the contract saying that SP reserves title in the goods until Company has paid for them in full and, further, until Company has discharged all its obligations to SP under all other contracts.

Pre-PPSA, a provision like this would have been valid as a matter of sales law. The sale of goods legislation allows a seller to reserve title and it does not restrict the seller's freedom to stipulate the conditions on which title will pass. The leading case was *Armour v Thyssen Edelstahlwerke AG*.⁴¹ Assume that, in Example 6, Company had previously given Bank a floating charge. Company pays SP for the spare parts under the contract in question, but defaults on another obligation owing to SP. The implication of the *Armour* case is that if Bank and SP both claimed the spare parts, SP would have priority.

The PPSA is less generous to SP in this respect. Applying s 14(3): (1) SP has a security interest in the goods supplied which secures Company's obligations under the contract in question and all other contracts as well; (2) SP's security interest is a pmsi in so far as it secures Company's obligation to pay for the goods supplied; and (3) SP holds a non-pmsi security interest in the goods supplied to secure Company's other obligations. Assume that, in Example 6, Bank holds a

³⁸ See Cumming, Walsh and Wood, above n 36, 332 and cases cited there: *Wheatland Industries (1990) Ltd v Baschuck* (1994) 8 PPSAC (2d) 247 (Saskatchewan Queen's Bench) and *Re 1151162 Ontario Ltd* (1997) 13 PPSAC (2d) 16 (Ontario Court General Division).

³⁹ Section 9-103(f)(1) and (2).

⁴⁰ *Clark Equipment of Canada Ltd v Bank of Montreal* [1984] 4 WWR 519 (Manitoba Court of Appeal).

⁴¹ [1991] 2 AC 339 (Scotland).

prior registered security interest in all Company's present and after-acquired personal property. As a consequence of s 14(3), while SP would have priority over Bank for the spare parts to enforce Company's obligation to pay for them, it does not have the same priority when it is relying on the security interest to enforce other obligations.

PPSA, s 14(4) provides, in effect, that a security interest does not lose its pmsi status simply because collateral other than purchase-money collateral also secures the purchase money obligation.

Example 7. SP supplies Company with motor vehicle spare parts for resale in Company's dealership business. There is a provision in the contract saying that SP reserves title in the goods until Company has paid for them in full and, to further secure payment, Company gives SP a security interest in all its other present and after-acquired inventory.

As a matter of pre-PPSA law, on the same reasoning as in Example 6, SP's retention of title claim would have prevailed over a pre-existing floating charge but, by the same token, its security interest in Company's other inventory quite possibly would not.⁴² The PPSA gets to a roughly comparable result. Applying s 14(4): (1) SP has a security interest in the goods supplied, and all Company's other present and after-acquired inventory as well, to secure payment for the goods supplied; (2) SP's security interest in the goods supplied is a pmsi; and (3) SP's security interest in the remaining collateral is not a pmsi. Given that SP's security interest in the remaining collateral is not a pmsi, the residual first to register priority rule applies and so SP's security interest is subordinate to a prior registered security interest in the same collateral.

Example 8. SP sells Company a printing press for use in Company's publishing business. The sale is on reservation of title terms and the contract price is \$25,000. Later SP sells Company a second printing press, again on reservation of title terms, for a price of \$50,000. Both contracts contain a provision saying that the security interest secures payment for not only the goods sold under the contract in question, but also goods SP may sell to Company under any other contract.

Again applying s 14(4): (1) SP has a pmsi in the first printing press to secure payment of the \$25,000 purchase money obligation owing under the first contract; (2) SP has a pmsi in the second printing press to secure payment of the \$50,000 purchase money obligation

⁴² The additional security interest would be a registrable charge and its priority relative to a prior registered floating charge would depend on the terms of the floating charge agreement as notified on the register: see note 11, above.

owing under the second contract; (3) SP has a non-purchase money security interest in the first printing press to secure payment of the \$50,000 owing under the second contract; and (4) SP has a non-purchase money security interest in the second printing press to secure payment of the \$25,000 owing under the first contract.

To see the significance of this analysis, assume that, in Example 8, before either purchase, Company gave Bank a security interest in all Company's present and after-acquired personal property and Bank registered a financing statement. Some time after the second contract with SP, Company defaults and the two printing presses are sold for \$20,000 and \$40,000, respectively. There is \$15,000 owing to SP for the first printing press and \$45,000 owing for the second printing press.⁴³ Bank and SP each claim the sale proceeds. SP has pmsis in both printing presses but, as a consequence of PPSA s 14(4), it does not have priority over Bank for the entire \$60,000 sale proceeds. SP has a pmsi in the first printing press only for the \$15,000 that is owing under the first contract, and it has a pmsi in the second printing press only for the \$45,000 that is owing under the second contract. Taking first the \$20,000 proceeds from the sale of the first printing press, on the assumption that SP has complied with the registration requirements in PPSA s 62, it has priority over Bank for \$15,000 by virtue of its pmsi; Bank is entitled to the remaining \$5,000 by virtue of its earlier registration. Turning to the \$40,000 proceeds from the sale of the second printing press, this amount is less than the purchase money obligation owing under the second contract (\$45,000) and so, by virtue of its pmsi, SP has priority for the full amount.

(d) *Allocation of Payments*

Example 9. Company gives Bank a security interest in all its present and after-acquired personal property and Bank registers a financing statement. Later SP sells Company a consignment of yellow motor vehicle spare parts for resale in Company's business. The sale is on reservation of title terms and the price is \$25,000. Later still, SP sells Company a second consignment of spare parts, this time green ones, again on reservation of title terms for a price of \$50,000. Both contracts contain a provision saying that the security interest secures payment for not only the goods sold under the contract in question, but also goods SP may sell to Company under any other contract. Eventually Company defaults, having made payments to SP totalling \$25,000. There is no indication of how Company and SP intended these payments to be allocated

⁴³ This example and the analysis which follows is adapted from Cuming, Walsh and Wood, above n 36, 343–5.

between the two contracts. There are yellow and green spare parts supplied by SP still in Company's stock which Bank and SP both claim.

Applying PPSA, s 14(4): (1) SP has a pmsi in the yellow spare parts to secure payment of the purchase money obligation owing under the first contract; (2) SP has a pmsi in the green spare parts to secure payment of the purchase money obligation owing under the second contract; (3) SP has a non-purchase money security interest in the yellow spare parts to secure payment of the purchase money obligation owing under the second contract; and (4) SP has a non-purchase money security interest in the green spare parts to secure payment of the purchase money obligation owing under the first contract.

The challenge in Example 9, though, is to identify the amounts of the respective outstanding purchase money obligations to determine Bank's and SP's entitlements. In the absence of any agreement between SP and Company governing allocation of payments or of any relevant statutory provision, a court might address the problem by applying the rule in *Clayton's Case*, otherwise known as the first-in, first out rule.⁴⁴ On this basis, SP's \$25,000 payments would all be allocated to the first contract so as to discharge the purchase money obligation in respect of the yellow spare parts. Since SP's security interest in the yellow spare parts no longer secures a purchase money obligation, it cannot be a pmsi. Therefore, as between Bank and SP, the ordinary priority rule applies and, since Bank registered first, it has priority over SP with respect to the yellow spare parts. But SP retains a pmsi in the green spare parts for the \$50,000 purchase money obligation owing under the second contract and, assuming SP has complied with the PPSA s 62 registration requirements, it will have priority over Bank for the green spare parts. On the other hand, instead of applying the rule in *Clayton's Case*, a court might decide to apportion SP's \$25,000 payments between the two contracts pro rata according to the obligations secured. On this basis, one third of SP's \$25,000 payments would be allocated to the first contract, and two thirds to the second contract. If the court adopted this approach, SP would retain a pmsi in the yellow spare parts for the balance of the purchase money obligation outstanding under the first contract, and it would retain a pmsi in the green spare parts for the balance of the purchase money outstanding under the second contract. In other words, SP would have partial priority over Bank in respect of both the yellow and green spare parts.

The PPSA, s 14(6) resolves the uncertainty by enacting a statutory rule for allocation of payments in cases where the parties have

⁴⁴ *Devaynes v Noble* ('*Clayton's Case*') (1816) 35 ER 767, 781 (Rolls Court).

not themselves agreed on a method of allocation. The provision reads as follows:⁴⁵

In any transaction, if the extent to which a security interest is a purchase money security interest depends on the application of a payment to a particular obligation, the payment must be applied:

(a) in accordance with any method of application to which the parties agree; or

(b) if the parties do not agree on a method--in accordance with any intention of the debtor manifested at or before the time of the payment; or

(c) if neither paragraph (a) nor (b) applies--in the following order:

(i) to obligations that are not secured, in the order in which those obligations were incurred;

(ii) to obligations that are secured, but not by purchase money security interests, in the order in which those obligations were incurred;

(iii) to obligations that are secured by purchase money security interests, in the order in which those obligations were incurred.

Applying this provision to the facts of Example 9, on the assumption that neither paragraph (a) or (b) applies, the governing rule is in para (c)(ii): SP holds a non-purchase money security interest in the yellow spare parts to secure payment of the obligation arising under the second contract and it has a non-purchase money security interest in the green spare parts to secure payment of the obligation arising under the first contract; the obligation under the first contract was incurred before the obligation under the second contract; and so SP's \$25,000 payment is allocated to the first contract. Given that this extinguishes the purchase-money obligation with respect to the yellow spare parts, it follows that SP no longer enjoys pmsi status with respect to the yellow spare parts.

The effect of s 14(6)(c) is to maximise the reach of a purchase-money security interest by keeping the purchase money obligation

⁴⁵ Compare Uniform Commercial Code – Secured Transactions, s 9-103(e). There is no corresponding provision in any of the Canadian provincial PPSAs, though some of the statutes do contain the following provision:

A purchase money security interest in an item of collateral does not extend or continue in the proceeds of the item after the obligation to pay the purchase price of the item or to repay the value given for the purpose of enabling the debtor to acquire rights in it has been discharged'.

See eg, Saskatchewan PPSA s 34(10). The purpose of the provision is to reverse the decision in *Chrysler Credit Canada Ltd v Royal Bank of Canada* (1986) 30 DLR (4th) 616: see Cuming, Walsh and Wood, above n 36, 344–5.

intact until the debtor has paid off all its other obligations to the secured party. However, the provision may be overridden by a contrary intention on the debtor's part, manifested at or before the time of payment. The implication is that it may be unsafe for the secured party to rely on para (c) and, to avoid the risk, it should incorporate an express allocation of payments provision in the contract.

Assume that in Example 9, the spare parts SP supplies under both contracts are all yellow ones. The above analysis presupposes that it is possible to differentiate between the yellow spare parts supplied under the first contract and the yellow spare parts supplied under the second contract but, unless Company has kept the two consignments separate or marked them in some way, they may be indistinguishable. In these circumstances, a court may deny SP pmsi status altogether on the ground that SP has not satisfied the burden of proof.⁴⁶ In the United States, Article 9, s 9-103(b)(2) provides that a security interest is a pmsi:

if the security interest is in inventory that is or was purchase-money collateral, also to the extent that the security interest secures a purchase-money obligation incurred with respect to other inventory in which the secured party holds or held a purchase-money security interest.

Applying this provision to our fact situation, both SP's security interests are pmsis to the extent of the purchase money obligations under both contracts. This makes it unnecessary to determine whether any given spare part belongs to the first consignment or the second one. However, although the pmsi definition in PPSA, s 14 is modelled in some respects on the Article 9 definition, Australia has not adopted this part of the provision.

(e) *Refinancings and Consolidations*

The PPSA s 14(5) provides that a security interest does not lose its pmsi status only because the purchase money obligation is renewed, refinanced, consolidated or restructured (whether or not by the same secured party).⁴⁷

Example 10. SP sells Company a printing press, on reservation of title terms, for use in Company's publishing business. Later SP sells Company a spare part for the

⁴⁶ Compare Uniform Commercial Code – Secured Transactions, s 9-103(g), which provides that a secured party claiming a pmsi has the burden of establishing the extent to which the security interest is a pmsi. There is some Canadian case law to the same effect: see eg, *Re Gerrard* (2000) 20 CBR (4th) 90 (Nova Scotia Supreme Court).

⁴⁷ Compare Uniform Commercial Code – Secured Transactions, s 9-103(f)(3).

press. The sale is on credit terms, but SP does not reserve title. Later still the parties consolidate the two transactions.

Section 14(5) makes it clear that SP does not lose its pmsi status with respect to the printing press as a result of the consolidation. The allocation rules in s 14(6) will apply to determine the apportionment of post-consolidation repayments between the two parts of the consolidated obligation. The same provisions apply to the consolidation of a pmsi agreement with a non-pmsi agreement and to the consolidation of two or more pmsi agreements.

The analysis becomes more complicated where a third party refinances the original pmsi transaction.

Example 11. Company gives Bank a security interest in all its present and after-acquired personal property and Bank registers a financing statement. Later SP sells Company a printing press for use in Company's publishing business. The sale is on reservation of title terms and the contract price is \$25,000. SP registers a financing statement within the time limit prescribed by PPSA s 62. Later still Company negotiates a loan from Financier for the purpose of paying out its contract with SP. Financier takes a security interest in the printing press to secure repayment of the loan. Company ends up in financial difficulty and Financier and Bank both claim the printing press.

The outcome of the dispute between Bank and Financier depends on whether Financier's security interest qualifies as a pmsi. The starting point is s 14(1)(b), which provides that the loan must be for the purpose of enabling Company to acquire rights in the press. However, Company already owns the press at the time of Financier's arrival on the scene and so it is hard to see how Financier's loan can be for the purpose stated in s 14(1)(b). It is true that the refinancing results in the discharge of SP's security interest in the press but this does not enlarge Company's rights because, in the end, SP's security interest is simply replaced by Financier's security interest; Company's rights in the press are the same as they were before the refinancing, the only difference being the identity of the secured party.⁴⁸

In Example 11, Financier took a new security interest in the press presumably on the understanding that SP's security interest was extinguished when SP was paid out. An alternative way of proceeding

⁴⁸ But see *Battlefords Credit Union Ltd v Ilnicki* (1991) 82 DLR (4th) 69 (Saskatchewan Court of Appeal) and *Unisource Canada Inc v Laurentian Bank of Canada* (2000) 47 OR (3d) 616 (Ontario Court of Appeal), critically analysed in Anthony Duggan, 'Hard Cases, Equity and the PPSA' (2000) 34 *Canadian Business Law Journal* 129. See also *New Zealand Bloodstock Leasing Ltd v Jenkins* [2007] NZHC 336 [58], questioning the correctness of *Ilnicki* and *Unisource* on the grounds stated in the text.

might have been for SP to assign its security interest in the press to Financier as security for Financier's loan to Company. If the parties had structured their transaction this way, PPSA s 60 would have applied. Section 60 provides that if a security interest is transferred, the transferred interest has the same priority immediately after the transfer as it had immediately before the transfer. Applying this provision to the facts of the case, immediately before the transfer SP had priority over Bank by virtue of its pmsi status, following the transfer Financier succeeds to SP's priority position and so Financier has priority over Bank.

The PPSA at large takes a substance over form approach to the regulation of security interests and it would be a triumph of form over substance if the priorities between Financier and Bank were to depend on how the parties happened to have structured their transaction. The PPSA s 14(5) is relevant in this connection. It provides in part that a security interest does not lose its pmsi status only because the purchase money obligation is refinanced '*whether or not by the same secured party*'. The wording could be clearer, but the implication seems to be that, on the facts of Example 11, Financier inherits SP's pmsi status. However, there is more to the story because, to obtain priority over Bank, in addition to proving that its security interest is a pmsi, Financier must also comply with the s 62 registration requirements. If the collateral is goods other than inventory, s 62 requires the pmsi-holder to register a financing statement within 15 business days after the grantor obtains possession of the collateral.

In Example 11, it is hard to see how Financier can satisfy this requirement given that considerably more than 15 days is likely to have elapsed between the date Company took delivery of the press from SP and the date of the refinancing agreement. Canadian courts have addressed this problem by holding that the debtor notionally takes possession of the collateral, vis-a-vis the refinancing lender, when the new funds are applied to pay out the old obligation. On this basis, the 15 days starts to run, not from the date the debtor originally obtained possession of the collateral, but from the date of the refinancing.⁴⁹ It remains to be seen whether Australian courts will take the same approach. Assuming they do then, in Example 11, Financier will obtain priority over Bank provided it registers a financing statement, in compliance with s 62, no later than 15 business days after the date of the refinancing.

An alternative approach might be for Financier to rely on the equitable doctrine of subrogation. Subrogation involves the substitution

⁴⁹ See eg, *Farm Credit Corporation v Gannon* [1993] 6 WWR 736 (Saskatchewan Queen's Bench); *Unisource Canada Inc v Laurentian Bank of Canada* (2000) 47 DLR (3d) 616 (Ontario Court of Appeal).

of one party (B) for another (A) so that B takes over A's rights in respect of a claim. At general law, the doctrine of subrogation applies in a case where a third party, at the grantor's request, pays off a first-ranking security interest on the understanding that it will inherit the original secured party's priority position. All the PPSAs, and Article 9, include a provision which preserves the operation of the general law in so far as it is capable of applying consistently with the statute,⁵⁰ and there are Canadian and United States authorities suggesting that the doctrine of subrogation may apply in a case like Example 11.⁵¹ Under the doctrine of subrogation, Financier would step into SP's shoes with respect to its rights against Bank. In other words, Financier succeeds to SP's priority position.

However, subrogation is a derivative right, in other words, Financier's rights are co-extensive with the rights SP previously enjoyed. The implication is that if SP has complied with the s 62 registration requirements so as to qualify for super-priority, then Financier has super-priority too — even if Financier has not itself complied with s 62. On the other hand, if SP has not complied with the s 62 registration requirements and so is disqualified from super-priority, Financier is disqualified too. The result would be the same if Financier had taken an assignment of SP's pmsi and PPSA, s 60 applied. Under s 60, the assignee automatically succeeds to the assignor's priority position. This means that if SP has complied with the s 62 registration requirements, there is no need for Financier to register its own financing statement. On the other hand, it also means that if SP has not complied with the s 62 registration requirements, Financier will not have the benefit of the super-priority rule. In other words, s 60 mimics the doctrine of subrogation in its application to the case under discussion.

To see the implications of the different approaches, assume that in Example 11, SP registers more than 15 business days after Company takes delivery of the press, while Financier registers within 15 business days after the date of the refinancing. On these facts, SP does not get the benefit of the super-priority rule in s 62. However, if s 14(5) applies, Financier may do so (subject to how the courts interpret the s.62 registration requirements). By contrast, if Financier relies instead on the doctrine of subrogation, or if PPSA s 60 applies, Financier cannot achieve a better priority position than SP had.⁵²

⁵⁰ In Australia, see PPSA s 254.

⁵¹ The cases are discussed in Cuming, Walsh and Wood, above n 36, 378–9.

⁵² *Ibid* 351–2.

D Requirements for Super-Priority

The PPSA s 62 sets out the requirements a pmsi-holder must satisfy to qualify for super-priority: the pmsi holder must perfect its security interest by registration and the financing statement must disclose that the security interest is a pmsi.⁵³ If the collateral is inventory, the pmsi-holder must register before the grantor obtains possession, but in any other case — for example, if the collateral is equipment — the pmsi-holder has up to 15 business days after delivery to register a financing statement. The reason for the 15 day grace period in the case of non-inventory collateral is a logistical one. Returning to Example 2, above, Company may be anxious to take delivery of the printing press quickly and SP2 may be concerned that if it does not make immediate delivery, it will lose the sale. The grace period avoids the need for SP2 to postpone delivery until after it has registered a financing statement. If the collateral is inventory, the statute does not provide a grace period. The reason is that the inventory supplier's arrangement with the buyer is likely to be an ongoing one and, in that case, SP can register a single financing statement at the outset of the relationship. The upfront registration perfects all later security interests in the same collateral type and avoids the need to register again.⁵⁴ On this basis, SP does not need a grace period.

If the collateral is inventory, the pmsi-holder's financing statement must disclose that the security interest is a pmsi. The Canadian PPSAs and Article 9 take a different approach. In Canada and the United States, if the collateral is inventory, the pmsi-holder must, in addition to the timely registration requirement, also serve a notice on every other secured party who has registered a financing statement claiming a security interest in the debtor's inventory.⁵⁵ For instance, in Example 9, above SP would have to serve the notice on Bank before it delivered the first consignment of spare parts. The notice must be in writing and it must indicate that SP expects to acquire a pmsi in

⁵³ In other words, if a secured party holds a pmsi but fails to make the pmsi disclosure in the financing statement, it loses its super-priority status: PPSA s 153(1), Table Item 7; *Personal Property Securities Regulations 2010* (Cth) s 5.5, Schedule 1, cl 3.1. In the reverse case where the secured party does not have a pmsi but falsely claims in the financing statement that it does, the consequence is to invalidate the registration so that the security interest is unperfected: PPSA ss 164 and 165.

⁵⁴ See PPSA s 21(4).

⁵⁵ See eg. Saskatchewan PPSA s 34(3); Uniform Commercial Code – Secured Transactions, s 9-324(b). In some Canadian provinces, the notice must also be sent to any prior registered secured party claiming a security interest in the debtor's accounts, eg. Ontario PPSA s 33(1).

Company's inventory. It must also include a description by item or kind of the inventory in question.⁵⁶

The notice serves as a warning to Bank about SP's pmsi. The idea is to alert Bank to the risk that its security interest in Company's inventory may be subordinated to SP's claim. This information may be important, particularly if Bank is making advances to Company on a regular basis, for example, under a line of credit. In cases like this, Bank needs to know, before each new advance, whether Company holds sufficient collateral to support the additional obligation. The notice alerts Bank to the fact that, even though Company has new inventory in stock, Bank may not have priority for it. It is true that Bank could find out this information for itself by conducting a register search, but it would have to conduct a register search before every new advance and this may be impractical. In summary, the notice requirement saves Bank from having to search the register before every new advance.⁵⁷

There is no notice requirement in PPSA s 62. Instead, there is a requirement for the pmsi-holder to disclose in its financing statement that it holds a pmsi. Returning to Example 9, this approach is less useful to Bank because, in order to find the disclosure, it will have to conduct a register search. Once Bank has conducted the search, it will be on notice of SP's pmsi, but that is not the end of the story. When it comes time for the next new advance, Bank will need to worry not only about SP's pmsi, but also the possibility that Company may have obtained new inventory from an alternative source which is also claiming pmsi status. To guard against this possibility, Bank should conduct another register search. In summary, PPSA s 62 does not obviate the need for Bank to conduct a register search before each new advance.

In New Zealand, the position is different again. Like Australia, New Zealand has jettisoned the notice requirement but, unlike Australia, it has not attempted to put anything in its place.⁵⁸ The justification for the New Zealand approach was that 'the pmsi super priority rule merely reflects the rights that title holders (such as suppliers retaining title under a 'Romalpa clause') would otherwise have had under the previous law, and that general financiers tended, in any case, to discount the value of inventory under their all assets security'.⁵⁹ The first part of this statement is clearly incorrect because,

⁵⁶ *Clark Equipment of Canada Ltd v Bank of Montreal* [1984] 4 WWR 519 (Manitoba Court of Appeal).

⁵⁷ See Cumming, Walsh and Wood, above n 36, 338.

⁵⁸ New Zealand PPSA s 74.

⁵⁹ Craig Wappett, Laurie Mayne and Anthony Duggan, *Review of the Law on Personal Property Securities: An International Comparison* (Commonwealth of Australia, Attorney-General's Department, 2006), [3.2.3].

as we have already seen, the PPSA changes the rights of *Romalpa* sellers in various respects.⁶⁰ The second part of the statement is a matter of empirical observation but, even if it is true, it overlooks the possibility that general financiers discount the value of inventory collateral because of the difficulties the notice requirement was designed to address. Returning to Australia, there is no discussion of the issue at all in the PPSA Explanatory Memorandum.⁶¹

E *Competing pmsis*

Example 12. On Day 1, SP1 takes a security interest in all Company's present and after-acquired personal property and registers a financing statement. On Day 2, SP2 negotiates the sale to Company of a printing press for use in Company's publishing business. Company agrees to make a 20 per cent down payment on the purchase price and to pay SP2 the balance by instalments under a *Romalpa* agreement. Company borrows the amount of the down payment from SP3 and gives SP3 a security interest in the press. SP3 registers a financing statement on Day 3. SP2 registers its financing statement on Day 5. Company defaults and SP1, SP2 and SP3 all claim the press.

SP2 and SP3 both have pmsis in the printing press, which is non-inventory collateral. Applying s 62(3), SP2 and SP3 both have priority over SP1. As between SP2 and SP3, the governing provision is s 63 which provides that, in a competition between a seller pmsi and a lender pmsi, the seller pmsi has priority provided the seller pmsi-holder has complied with the s 62 registration requirements. This means that, in Example 12, SP2 has priority over SP3. The justification is that SP3 (the lender) ought to suspect that Company may be financing the 80 per cent balance of the purchase price from another source and it can protect itself by making inquiries. By contrast, SP2 (the seller) typically will have no reason to suspect that there is another financier involved; for all SP2 knows, Company may be paying the deposit out of its own funds.

Example 13. On Day 1, SP1 takes a security interest in all Company's present and after-acquired personal property and registers a financing statement. On Day 2, SP2 negotiates the sale to Company of a printing press for use in Company's publishing business. Company borrows 60 per cent of the purchase price from SP2 and gives SP2 a security interest in the press. Company borrows the remaining 40 per cent of the purchase price from SP3 and gives SP3 a security interest in the press. SP3 registers a

⁶⁰ See text at notes 12–21 above. See further, Parts III and IV below.

⁶¹ Explanatory Memorandum, Personal Property Securities Bill 2009 (Cth).

financing statement on Day 3. SP2 registers its financing statement on Day 5. Company defaults and SP1, SP2 and SP3 all claim the press.

SP2 and SP3 have pmsis, so they both have priority over SP1. As between SP2 and SP3, s 63 does not apply because neither SP2 nor SP3 is a seller. In the absence of a specific rule to cover the case, the general priority rules in s 55 apply. SP2 and SP3 both have security interests perfected by registration and so SP3, being the first to register, has priority.

III Proceeds Claims

A The Pre-PPSA Position

Where inventory was sold on retention of title terms, it was common to find in the agreement a provision authorizing the buyer to resell the goods in the ordinary course of business but giving the seller a claim to the resale proceeds. Generally speaking, the courts were disinclined to uphold proceeds clauses; in the words of one commentator, 'it is almost as if the courts [were] drawing a line in the sand and saying to the supplier, "You can have your simple and current-account reservation of title clauses, but thus far and no further"'.⁶²

The main obstacle to proceeds clauses were the provisions in the *Corporations Act* requiring registration of a charge on book debts. If the proceeds took the form of accounts receivable and a court construed the proceeds clause as creating a charge in the original seller's favour, the clause would be void against the buyer's liquidator or administrator unless it was registered. Likewise, without registration, the seller's claim to the accounts would be subordinate to a registered charge on the same collateral while, even if registered, it would typically be subordinate to prior registered charges.⁶³ To avoid these outcomes, the seller had to convince the court that there was a fiduciary relationship between itself and the buyer and that the buyer resold the goods on the seller's behalf. This, in turn, provided a basis for concluding that the proceeds belonged in equity to the seller and that the function of the proceeds clause was not to create a new entitlement in the seller's favour but simply to affirm the seller's equitable interest.⁶⁴

⁶² McCormack, *Secured Credit*, above n 2, 182.

⁶³ See text at notes 9 and 10, above. The *Corporations Act* also required registration of a charge on a negotiable instrument (s 262(1)(j)) and so, if the resale proceeds took the form of cheques, the same issues would arise.

⁶⁴ Gullifer (ed), *Goode on Legal Problems of Credit and Security*, above n 8, [1]–[31].

But this line of argument is essentially counter-factual and, for the most part, the courts refused to subscribe to it. If the buyer really did resell the goods on the original seller's account, rather than on its own behalf, the logical conclusion is that the original seller would be entitled to the whole of the resale price, including the profit margin. This is unlikely to reflect the parties' actual intentions and it would deliver a windfall to the original seller.⁶⁵ Concerns about the windfall effect underlie much of the case law going against the seller. One way of addressing these concerns was for the agreement to limit the proceeds claim to the amount owing on the original sale. However, a provision like this undermines the argument that the buyer resold the goods on the original seller's account and it strengthens the view that the parties intended to create a charge. Furthermore, the original seller's claim to the proceeds would come to an end once the buyer paid the purchase price and this consideration reinforces the inference that the buyer resold the goods on its own account subject to a charge on the resale proceeds to secure payment of the original purchase price.⁶⁶

For these reasons, at least in England, 'there is very little chance of a reservation-of-title [proceeds] clause receiving judicial approval'.⁶⁷ On the other hand, in *Associated Alloys Pty Ltd v CAN 001 452 106*,⁶⁸ the High Court of Australia upheld a proceeds clause which required the buyer to hold the resale proceeds on trust for the original seller, declining to characterize the provision as giving rise to a registrable charge. The majority saw the key question as being whether the parties intended to create a trust and it treated their explicit use of trusts language as proof that they did. 'There is nothing to suggest', the court said, 'that the parties in their written instrument did not mean what they say, or did not say what they meant'.⁶⁹ Therefore there was no reason for not taking the parties at their word or for giving the bargain a different meaning from the way the parties themselves had expressed it.⁷⁰ The court recognized the commercial significance of its decision, saying that 'for third parties, such as financial institutions seeking to assess the credit-worthiness of the buyer, the non-registration of the proceeds sub-clause may cause potential difficulties'.⁷¹ However, it suggested that these difficulties 'were capable of remedy by legislation'.⁷² 'To treat the Proceeds Subclause as an agreement which falls foul of the [Corporations] Law is to rewrite the statute. It is not for

⁶⁵ McCormack, *Secured Credit*, above n 2, 185.

⁶⁶ *Ibid.*

⁶⁷ *Ibid.*

⁶⁸ (2000) 202 CLR 588.

⁶⁹ *Ibid* [35].

⁷⁰ *Ibid* [40].

⁷¹ *Ibid* [47].

⁷² *Ibid.*

the courts to destroy or impair property rights, such as those arising under trusts, by supplementing the list of those rights which the legislature has selected for such treatment.’⁷³ Kirby J, dissenting, cautioned against the ‘exclusive concentration on the terms of an instrument purporting to create a trust, to the neglect of an examination of the purpose and effect of the instrument when considered for its substance not merely its form’.⁷⁴ He concluded that the proceeds sub-clause did create a registrable charge and that any other construction ‘would permit the easy defeat of the clear purpose of the [Corporations] Law’.⁷⁵

B *The PPSA Reforms*

(a) *Introduction*

The PPSA enacts the reforms foreshadowed in the *Associated Alloys* case and it avoids the formalism inherent in that decision and earlier case law. The PPSA, s 32(1) creates a statutory right to proceeds and so it is no longer necessary for parties to include an express proceeds provision in their agreement⁷⁶ or to establish a fiduciary relationship as the basis for a proceeds claim.⁷⁷ This means that the need for formal characterization of a *Romalpa* seller’s proceeds claim, which was the main preoccupation of the pre-PPSA case law, no longer arises. The only question is whether the seller has a security interest in the original collateral and, as previously discussed, s 12 specifically states that, for the purposes of the statute, a conditional sale agreement is a security interest. The PPSA, s 62 makes it clear that a pmsi-holder’s super-priority extends to the proceeds of any dealing in the original collateral and, in contrast to prior law, this means that in most cases a *Romalpa* seller’s proceeds claim will have priority over competing security interests.⁷⁸

(b) *The Meaning of ‘Proceeds’*

The PPSA, s 31 defines proceeds to mean, in part, ‘identifiable or traceable personal property ... that is derived directly or indirectly

⁷³ Ibid [51].

⁷⁴ Ibid [92].

⁷⁵ Ibid [95].

⁷⁶ Section 20(6) reinforces this conclusion by making it clear that, while the security agreement must be in writing and contain a description of the original collateral, it is not necessary for the agreement to also describe the proceeds.

⁷⁷ See Cuming, Walsh and Wood, above n 36, 456–7.

⁷⁸ See s 62(2)(a) (‘the purchase-money security interest has priority if [it] is in inventory or its proceeds’); and s 62(3)(a) (‘the purchase-money security interest has priority if [it] is personal property or its proceeds’ (emphasis added)).

from a dealing with the collateral (or proceeds of the collateral)'. The provision makes it clear that 'proceeds' includes not just first generation proceeds but also second and subsequent generation proceeds.⁷⁹

Example 14. SP holds a purchase money security interest in Company's inventory. Company sells an item of inventory to Customer, in the ordinary course of business, on 90 day terms. At the end of the 90 days, Customer pays Company by cheque. Company cashes the cheque and uses the money to buy office supplies.

Company's sale to Customer gives rise to a money obligation owing by Customer to Company which, in PPSA parlance, is an 'account'.⁸⁰ The account is first generation proceeds of the original collateral. Customer's payment discharges the account, but now SP has a claim to the cheque ('negotiable instrument', in PPSA terms⁸¹) as first generation proceeds of the account and second generation proceeds of the original collateral. The cashing of the cheque terminates SP's interest in the cheque, but SP acquires an interest in the cash as proceeds of the cheque and likewise, when Company spends the cash on the office supplies, SP acquires an interest in the office supplies as proceeds of the cash.

To qualify as proceeds, the disputed asset must be 'identifiable or traceable personal property'. There has been some confusion over the meaning of this expression in the Canadian PPSAs, but the now generally accepted view is that 'identifiable' refers to the ability to point to the particular property obtained by the debtor as a result of the dealing with the collateral (or proceeds), while 'traceable' refers to the situation where the collateral is commingled with other property so that its identity is lost'.⁸² In Example 14, the account, the cheque, the cash and the office supplies are all identifiable personal property in the relevant sense. Assume that, instead of cashing the cheque and spending the proceeds, Company deposited the cheque in its bank account. If there were no other funds in the account, the money in the bank (or 'ADI account', in PPSA parlance⁸³) would also qualify as identifiable personal property. But if the proceeds of the cheque become mixed with Company's other funds in the bank account, they lose their identifiability and SP's claim to them depends instead on

⁷⁹ Section 31(3) provides that personal property is proceeds only if the grantor has an interest in the proceeds. So, for example, if the grantor sells property with the secured party's consent so that the buyer obtains clear title and the buyer later resells the property, the consideration the buyer receives from the sub-buyer is not proceeds: for discussion, see Cuming, Walsh and Wood, above n 36, 462-4.

⁸⁰ PPSA s 10 (definition of 'account').

⁸¹ PPSA s 10 (definition of 'negotiable instrument').

⁸² Cuming, Walsh and Wood, above n 36, 466.

⁸³ PPSA s 10 (definition of 'ADI account').

whether they are 'traceable'. The common law and equitable tracing rules are relevant in this connection, including the rule in *Re Hallett's Estate*⁸⁴ and the lowest intermediate balance rule.⁸⁵

Example 15. SP holds a purchase money security interest in Company's inventory. Company sells an item of inventory to Customer, in the ordinary course of business, for \$1,000 cash and deposits the money in its bank account. The account already contains \$500 of Company's own money. The following day, Company withdraws \$400, leaving \$1,100 in the account.

By analogy with the rule in *Re Hallett's Estate*, a court is likely to presume that Company's withdrawal was made against its own share of the mixed fund, leaving SP's entitlement intact.⁸⁶ On this basis, SP has a claim on the account for the entire \$1,000 sale proceeds. Assume that, in Example 15, there are two further movements in the account. The day after making the \$400 withdrawal, Company withdraws another \$200, leaving \$900 in the account. The day after that, it deposits \$800 of its own money so that the balance is now \$1,700. These facts engage the lowest intermediate balance rule, which states that a claimant to a mixed fund is limited to the smallest balance in the fund during the interval between the original contribution and the date of the claim. Applying the rule to the facts in question, SP's claim is limited to \$900, which was the lowest intermediate balance in the relevant period. Now assume that, in Example 15, Company's bank account is in overdraft at the time it deposits the \$1,000 proceeds. Deposits to an overdrawn account are applied in reduction of the customer's debt to the bank and so, as a general rule, they are not traceable.⁸⁷ The result would be the same if Company used the sale proceeds, for example, to pay wages or taxes.

⁸⁴ *Re Hallett's Estate; Knatchbull v Hallett* (1880) 13 Ch D 696. The following is a summary account only. For a detailed treatment of the tracing rules at large, see Lionel Smith, *The Law of Tracing* (Clarendon Press, 1997). For a fuller treatment of the tracing rules in the PPSA context, see Cuming, Walsh and Wood, above n 36, ch 12.

⁸⁵ *James Roscoe (Bolton) Ltd v Winder* [1915] 1 Ch 62.

⁸⁶ Smith, above n 84, 209–10.

⁸⁷ *Bishopsgate Investment Management Ltd v Homan* [1995] Ch 211; *Re Goldcorp* [1995] 1 AC 74, 104–5. For a PPSA case in support of the proposition, see *Flexi-Coil Ltd v Kindersley District Credit Union* (1993) 107 DLR (4th) 129 (Saskatchewan Court of Appeal). The proposition is subject to the so-called principle of 'backwards tracing', or 'tracing by subrogation', which holds that where the defendant uses the disputed funds to pay a debt, the funds may still be traceable if the defendant spent the loan on an asset he still owns: for discussion in the PPSA context, see Cuming, Walsh and Wood, above n 36, 475–6. Cf *Agricultural Credit Corporation of Saskatchewan v Pettyjohn* (1991) 79 DLR (4th) 22 (Saskatchewan Court of Appeal), where the court formulated a much broader exception to the rule against tracing into an overdrawn account. The case suggests that it may be appropriate for the courts to modify the traditional tracing rules in the PPSA context, having regard to the objectives of the statute. However, this aspect of the decision is

(c) *Perfection and Priorities.*

The PPSA s 33 sets out rules for the perfection of a security interest in proceeds. As a general rule, the collateral description in the financing statement must include a description of the proceeds, otherwise a searcher may not realise that the secured party's claim extends beyond the original collateral to the proceeds in question. Section 33(1) (a)-(c) provides for three automatic methods of perfection, while s 33(2) enacts a non-automatic method.⁸⁸ Section 33(1)(a) provides that if the collateral description in the original financing statement describes the proceeds in question, the financing statement as it stands perfects the security interest in the proceeds and the secured party does not need to do anything further. Item 4 in the Table appended to PPSA s 153(1) provides that any description of proceeds must comply with the Regulations. The Regulations prescribe three ways of describing proceeds: (1) as all present and after-acquired personal property; (2) by item; or (3) by class.⁸⁹ The register has been designed to make Item (1) the default option. If the secured party wants to claim proceeds, it must indicate its intention during the registration process by clicking the 'proceeds' option. At that point, the system will automatically populate the 'description of proceeds' field with 'all present and after-acquired property'. The secured party is free to replace this text with something else, but in most cases it will probably not do so.⁹⁰

This measure benefits the secured party by substantially simplifying the process of perfecting a security interest in proceeds. On the other hand, it diminishes the information given to searchers and it raises the question whether there is any point in having a perfection requirement for proceeds claims at all. Specifically, a register search will not reveal to the searcher whether any particular asset is, or may be, subject to a proceeds claim by a prior-ranking secured party. Consequently, in any subsequent dealings with the grantor, the searcher must factor in the risk that its entitlement to the asset in question may be subject to an undiscoverable proceeds claim. In terms of outcomes, the Australian approach resembles the Ontario PPSA which provides that a security interest in proceeds is automatically perfected if the security interest in the original collateral was perfected by registration

controversial, even in Canada, and it is unlikely an Australian court would follow it: see Cuming, Walsh and Wood, above n 36, 476–8; cf Brown and Sampson, above n 7, 107–8. See also Matthew Conaglen, 'Difficulties with Tracing Backwards' (2011) 127 *Law Quarterly Review* 432, arguing against backwards tracing on both legal and policy grounds.

⁸⁸ Compare New Zealand PPSA ss 46 and 47 and, eg, Saskatchewan PPSA ss 28(2) and (3).

⁸⁹ *Personal Property Securities Regulations 2010* (Cth) s 5.5, sch 1, cl 2.4.

⁹⁰ See the draft register screen shots published by the Attorney-General's Department; <<http://tinyurl.com/35ar2h6>>.

when the proceeds were generated.⁹¹ This feature of the Australian registration system makes the balance of PPSA s 33 largely redundant. However, for the sake of completeness, a short account follows.

Example 16. Company is a dealer in appliances. SP supplies refrigerators to Company on conditional sale terms and registers a financing statement which describes the original collateral as ‘commercial property – other goods’ and the proceeds as ‘intangible property – accounts’. Company sells a refrigerator to Customer on 12 months’ interest free credit terms.

In Example 16, SP has discarded the default option of describing the proceeds as ‘all present and after-acquired property’ in favour of a description by class, namely ‘intangible property — accounts’. Customer’s account fits the description and so SP holds a perfected security interest in Customer’s account without the need for any further action on its part.

Section 33(1)(b) provides that if the proceeds are property of the same kind as the original collateral and the financing statement correctly describes the collateral, the secured party’s original registration perfects its security interest in the proceeds.

Example 17. Company is a motor car dealer. SP supplies vehicles to Company on conditional sale terms and registers a financing statement which describes the collateral as ‘commercial property; motor vehicles’. Company sells a car to Customer and takes Customer’s old car as a trade-in.

SP’s security interest extends to Customer’s trade-in as proceeds of SP’s original collateral. SP’s financing statement describes the collateral as motor vehicles and so SP need to do nothing further to perfect its security interest in the trade-in.

Section 33(1)(c) provides that if the proceeds consist of currency, cheques, a deposit to an ADI account or an insurance payment, SP is automatically perfected, without reference to the wording of its collateral description.⁹²

If none of the s 33(1) rules apply, SP may rely instead on the temporary perfection rule in s 33(2). This provides that if a security interest is perfected in original collateral but not proceeds, the security interest is temporarily perfected in the proceeds for a period of five business days from the date the security interest attaches to the proceeds. The purpose is to give the secured party time to register a

⁹¹ Ontario PPSA s 25(2).

⁹² For the rationale, see Cuming, Walsh and Wood, above n 36, 480.

financing change statement amending its collateral description to cover the proceeds in question.

Example 18. Company is a dealer in appliances. On Day 1, SP supplies refrigerators to Company on conditional sale terms and registers a financing statement which describes the collateral as ‘commercial property – other goods.’ The financing statement makes no reference to proceeds. On Day 2, Company sells a refrigerator to Customer on 12 months interest free credit terms. On Day 3, Company goes into liquidation.

SP’s security interest extends to Customer’s account as proceeds of the refrigerator. None of the automatic perfection rules in s 33(1) applies here. However, SP’s security interest in the account is temporarily perfected for five business days from Day 2. If SP amends its collateral description during this period it will be treated for the purposes of the statute as having been continuously perfected from Day 2 up to and including Day 3. Consequently, its security interest will be effective against Company’s liquidator.⁹³ On the other hand, if SP fails to act, its security interest will become unperfected at the end of the five day period and SP may lose its secured creditor status in Company’s liquidation proceedings.⁹⁴

Example 19. SP (accounts) takes a security interest in Company’s present and after-acquired accounts⁹⁵ and registers a financing statement which identifies the collateral as all Company’s present and after-acquired accounts (‘intangible property’).⁹⁶ Later SP (inventory) supplies Company with motor vehicle spare parts for sale in Company’s business. The sale is on reservation of title terms and SP (inventory) registers a financing statement before delivering the goods. The financing statement indicates that SP (inventory)’s security interest is a pmsi. Company sells the spare parts to various customers on 90 day terms. Subsequently, Company runs into financial difficulties. The customer accounts in question are all still

⁹³ Subject to *Corporations Act 2001* (Cth) s 588FL: see note 30, above. The relevant date for the purposes of s 588FL is the date of SP’s original registration (the ‘registration time’), not the date of its registration amendment (‘the amendment time’): see PPSA s 10 (definitions of ‘amendment time’ and ‘registration time’); s 160.

⁹⁴ SP will still be protected if it amends its financing statement after the 5 day period but before the commencement of the liquidation proceedings. In that case, SP will have been temporarily perfected during the 5 days, unperfected from the end of the five days to the date of its financing change statement and perfected again thereafter.

⁹⁵ Or, alternatively, takes an outright assignment. The analysis is the same either way, because the assignee under an outright assignment is deemed to hold a security interest for the purposes of the statute: PPSA s 12(3)(a).

⁹⁶ The statutorily required collateral description for accounts is: ‘commercial property; intangible property’: see PPSA s 153(1) Table, Item 4; *Personal Property Security Regulations 2010* (Cth), s 5.5 sche 1, cl 2.3.

outstanding. SP (accounts) claims the accounts as original collateral. SP (inventory) claims the accounts as proceeds of the inventory it supplied to Company.

If PPSA s 62 applied, SP (inventory) would have priority. The super-priority rule in s 62 applies not only to the goods originally supplied, but also to sale proceeds and the customer accounts are proceeds of the inventory SP (inventory) supplied. However, s 64 enacts a special priority rule for disputes of this nature. It provides that, in general, the priority between SP (accounts) and SP (inventory) is to be determined on a first in time basis which, in most cases will translate to a first to register rule. This is consistent with the approach taken in Article 9 and most of the Canadian provincial PPSAs.⁹⁷

However, s 64 goes on to provide a way for SP (accounts) to claim priority over SP (inventory), even if SP (inventory) was the first to register. To qualify for this super-priority status, SP (accounts) must serve a notice on SP (inventory) in an approved form. The notice must be given to SP (inventory) at least 15 business days before the date SP (accounts) registers its financing statement or the date SP (accounts)'s security interest attached to the account, whichever is earliest.⁹⁸ According to the Explanatory Memorandum, the purpose of the notice is to give 'the inventory financier time to protect its security interest by altering the terms of trade for future inventory finance that would become subordinate to [the accounts financier's interest]'.⁹⁹ Section 64(3) offers the subordinated inventory financier (SP inventory) a consolation prize of sorts. It gives SP (inventory) a deemed pmsi in the loan funds Company received from SP (accounts) and it waives any new registration requirement. The upshot is to qualify SP (inventory) for super-priority status under s 62 with respect to the funds in question. SP (inventory)'s capacity to enforce this claim will of course depend on the funds being traceable in Company's hands and this may not be the case if, for example, Company has used the money to pay wages or taxes or to pay down its overdraft.

In common with Article 9, all PPSA jurisdictions concede that the pmsi super-priority rule is inappropriate in a case like Example 19,

⁹⁷ Uniform Commercial Code – Secured Transactions, s.9-324(b). See also, eg, Saskatchewan PPSA s 34(6). New Zealand has also taken this approach: New Zealand PPSA s 75A.

⁹⁸ Assume that in Example 19, the security agreement between SP (accounts) and Company is concluded on Day 1. Company has 25 customer accounts outstanding on Day 1. Thirty new accounts are generated on Day 5. SP (accounts) registers on Day 3. With respect to the 25 Day 1 accounts, the 15 day period runs from Day 1: Day 1 is the date of attachment and it precedes the registration date (Day 3). With respect to the 30 Day 5 accounts, the 15 day period runs from Day 3: Day 3 is the registration date and it precedes the date of attachment which is Day 5.

⁹⁹ Explanatory Memorandum, Personal Property Securities Bill 2009 (Cth), above n 60, [2.145].

at least without some modification. Cuming explains the reason as follows:

‘every accounts financier who has registered a financing statement and has loaned money to a debtor ... [would face] the risk of loss of his security to subsequent inventory financiers claiming purchase money security interests in the debtor’s accounts. There are no measures an account financier can take to protect himself. The result is that accounts financiers must make sure that any advances they make are fully secured by existing accounts which cannot be traced as the proceeds of sale of a debtor’s inventory’.¹⁰⁰

On the other hand, a first to register rule is justifiable because:

‘If a secured party is approached by a potential customer seeking inventory financing, he will conduct a search of the registry to determine whether or not any priority claims to the potential customer’s account have been registered. If the search reveals a prior claim, the inventory financier must decide whether or not he would be adequately secured without having as collateral the accounts that are the proceeds of his inventory. The decision that the accounts are necessary may, but need not, lead to the conclusion that the potential customer must be turned away. The accounts financier may be prepared to execute a subordination agreement giving the inventory financier priority to the accounts which are proceeds of his inventory. In any event, if priority is given to the accounts financier, the inventory financier is in a position to take measures to avoid loss to anyone simply by refusing to deal with the person seeking further credit’.¹⁰¹

However, while these considerations justify a first to register rule in preference to a super-priority rule favouring the pmsi-holder, they do not justify taking the further step of giving super-priority to the accounts financier instead. There is no explanation in the Explanatory Memorandum for the Australian approach. In any event, there is a loophole in s 64 that may assist the pmsi-holder. The section only applies if the pmsi-holder is claiming accounts ‘as proceeds of inventory’. Suppose that, in Example 19, SP (inventory) is the first to register. Suppose also that SP (inventory) takes a security interest not only in the spare parts it supplies to Company, but also in Company’s present and after-acquired accounts.¹⁰² This enables SP (inventory) to

¹⁰⁰ Ronald C C Cuming, ‘Second Generation Personal Property Security Legislation in Canada’ (1981-82) 46 *Saskatchewan Law Review* 5, 39.

¹⁰¹ *Ibid* 38–9.

¹⁰² Note the difference between a claim to accounts as original collateral and a claim to accounts as proceeds. For a claim to accounts as original collateral, the collateral

claim the accounts as original collateral, not proceeds, and so s 64 does not apply. The pmsi super-priority rule in s 62(2) does not apply either because it is limited to the case where the pmsi-holder's claim is to inventory or its proceeds. In the absence of any other relevant provision, the priority rule in s 55(4) applies and since, in the scenario under consideration, SP (inventory) registered before SP (accounts), SP (inventory) has priority.

IV Commingled Goods and Accessions

A Commingled Goods

(a) *The Common Law Position*

At common law, if goods supplied under a reservation of title agreement are later used in a manufacturing process to create a new end product, the manufacturer becomes the owner of the end product and the *Romalpa* seller's title to the inputs is extinguished.¹⁰³ The parties may attempt to displace this outcome by including in the agreement a provision, commonly known as an 'aggregation clause',¹⁰⁴ stipulating that ownership of the end product is to vest in the supplier. Such a provision will 'almost invariably be treated as creating a mortgage or charge' over the end product, and so it would be subject to the registration of charges provisions in the *Corporations Act*.¹⁰⁵ A leading English case is *Borden (UK) Ltd v Scottish Timber Products Ltd*.¹⁰⁶ In that case, the seller supplied resin to the buyer on reservation of title terms and the resin was combined with other raw materials to manufacture chipboard. There was no aggregation clause in the parties' contract, but the seller argued that it was entitled to trace its interest in the resin into the end product. The court rejected the seller's claim on the ground that its title to the resin disappeared once it had been used up in the manufacturing process and that if the seller wanted to acquire rights in the end product, this could only be done by an express contractual stipulation.

description in the security agreement must refer to accounts. For a claim to accounts as proceeds, there is no need for the security agreement to say anything because the statute creates an automatic right to proceeds: see Part III B (a), above. In either case, failure to describe the accounts in the financing statement may mean that the security interest is unperfected as to the accounts but describing the accounts in the financing statement is neither a necessary nor a sufficient condition for the creation of a security interest in the accounts as original collateral.

¹⁰³ See eg., Beale et al, above n 4, [5.14]; McCormack, *Secured Credit*, above n 2, 196–7; Gullifer (ed), *Goode on Legal Problems of Credit and Security*, above n 8, [1-32].

¹⁰⁴ McCormack, *Secured Credit*, above n 2, 199.

¹⁰⁵ *Ibid.*

¹⁰⁶ [1981] Ch 25.

In a later case, *Re Peachdart Ltd*,¹⁰⁷ the agreement did contain an aggregation clause but the court, relying on *Borden*, held that since the seller's title to the inputs was lost in the manufacturing process, its interest in the end product could only be by way of grant and so it was a registrable charge. In *Clough Mill Ltd v Martin*,¹⁰⁸ Robert Goff LJ suggested that it might be possible to draft an aggregation clause which avoids this outcome by providing that title to the end product ipso facto vests in the *Romalpa* seller at the point of manufacture. However, even if this is possible, it is unlikely to reflect the parties' real intentions; the provision would give the *Romalpa* supplier a windfall because it would take the benefit of the buyer's labour together with other materials that might have belonged to the buyer. The windfall effect becomes even more acute where the end product includes materials sourced from two or more suppliers all with competing claims.¹⁰⁹

(b) *The PPSA Position*

The PPSA commingled goods provisions avoid these difficulties and, in the process, substantially simplify the law. The commingled goods provisions apply where goods subject to a security interest are 'so manufactured, processed or commingled that their identity is lost in the product or mass'.¹¹⁰ Section 99(1) provides that a security interest in commingled goods continues in the end product. In other words, the security interest attaches automatically to the end product and there is no need for any aggregation clause in the security agreement. In short, the statute effectively sidesteps the analytical complexity displayed in *Borden* and the other pre-PPSA cases.

In the *Borden* case, the buyer was in liquidation and the action was brought against a receiver, who had been appointed by debenture-holders, in his capacity as provisional liquidator. If the PPSA had applied, the case would have been resolved along the following lines. The supplier held a security interest in the resin as original collateral. Applying s 99(1), the supplier's security interest continued in the chipboard. The PPSA s 267 provides, in substance, that an unperfected security interest is ineffective against the grantor's liquidator. Therefore the success of the supplier's claim would have depended on whether its security interest in the chipboard was perfected. Assuming the supplier had registered a financing statement to perfect its security interest in the resin, the collateral description, if completed in accordance with the

¹⁰⁷ [1984] Ch 131.

¹⁰⁸ [1985] 1 WLR 111.

¹⁰⁹ Gullifer (ed), *Goode on Legal Problems of Credit and Security*, above n 8; McCormack, *Secured Credit*, above n 2, 200–1; Beale et al, above n 4, [5.16]–[5.17].

¹¹⁰ PPSA s 99(1). This definition covers cases of both manufacture or 'specification', to use the common law term, and mixing or 'confusion' (as where two or more quantities of fungible goods, such as wheat, become mixed together in the same silo): Cuming, Walsh and Wood, above n 36, 504.

statutory requirements, would have read: 'commercial property; other goods'.¹¹¹ This description is wide enough to cover the chipboard as well as the resin and so the supplier would have held a perfected security interest in the chipboard.¹¹² There is a potential windfall effect in this outcome because the value of the end product may exceed the value of the supplier's inputs and so, if the supplier was under-collateralised to start with, it may end up better off as a result of the commingling. The PPSA s 101 attempts to address the windfall problem. It limits the supplier's claim to the value of its inputs at the time they became part of the end product. However, the provision only applies in the case of a competition between two or more security interests continuing in the product or mass and so it would not apply in a *Borden*-type dispute. On the other hand, the underlying principle is the same in both cases and the courts might be prepared to imply the limitation across the board.¹¹³

In the pre-PPSA cases, the courts worried over the possibility of competing claims to the end product between two or more input suppliers.

Example 20. SP1 supplies Company, a chipboard manufacturer, with resin on reservation of title terms. The agreement includes an aggregation clause. SP2 supplies Company with wood chips, also on reservation of title terms and also subject to an aggregation clause. Company defaults against SP1 and SP2 and they both claim the chipboard manufactured from their products.

The lack of an obvious solution to disputes of this nature was one of the factors underlying the courts' hostility to aggregation clauses.¹¹⁴ Post-PPSA, both SP1 and SP2 would have statutory claims to the chipboard and so there would be no need for the aggregation clauses. This innovation increases the likelihood of Example 20-type disputes, but the PPSA rises to the challenge by enacting a set of simple priority rules to address such cases. The governing provisions are PPSA ss 102 and 103 and, in summary, the rules are as follows: (1) a perfected security interest in commingled goods has priority over an unperfected security interest in the same collateral; (2) if two or more

¹¹¹ PPSA s 153(1) Table, Item 4(a); *Personal Property Securities Regulations 2010* (Cth) s 5.5, sch 1, cl 2.3.

¹¹² The perfection rules for proceeds in s 33 do not apply because the chipboard is not proceeds; for proceeds, there must be 'a dealing' in the original collateral. A dealing implies some kind of exchange and manufacture is not a dealing in this sense: Cuming, Walsh and Wood, above n 36, 504–5. Section 100 provides that perfection of a security interest in commingled goods is to be treated as perfection also of the security interest in the end product. However, this provision is only for the purposes of the default priority rules in s 55 and it does not apply where the secured party's claim is against the grantor's liquidator or trustee in bankruptcy.

¹¹³ See Cuming, Walsh and Wood, above n 36, 509–10.

¹¹⁴ See McCormack, *Secured Credit*, above n 2, 200–1.

perfected security interests continue in the end product, the competing claimants share the end product according to a statutory ratio;¹¹⁵ (3) if two or more unperfected security interests continue in the end product, the competing claimants share the end product according to a corresponding statutory ratio;¹¹⁶ (4) a perfected pmsi that continues in the end product has priority over a non-pmsi that continues in the same input; and (5) a perfected pmsi that continues in the end product has priority over a non-pmsi in the end product given by the same grantor.

B Accessions

(a) The Common Law Position

Example 21. SP1 has a security interest in Company's truck, perfected by registration. SP2 supplies Company with new tyres on reservation of title terms and Company fits the tyres to the truck. Company defaults against SP1 and SP2 and they both claim the tyres.

At common law, the outcome of this type of dispute was governed by the doctrine of accession. The doctrine of accession is analogous to the law governing fixtures: the fixtures doctrine applies where A's goods become attached to B's land and A and B, or a third party holding an interest in B's land, both claim the fixture. The accessions doctrine applies where, as in Example 21, A's component becomes attached to B's host goods and A and B, or a third party holding an interest in the host goods, both claim the component.

The accessions doctrine provided an all-or-nothing solution to cases like Example 21. If the court found that the component had become an accession, the result was that title in the component passed to the owner of the host goods and the original component owner's claim was extinguished. The courts relied on various competing tests to determine when accession occurs. One approach was to ask whether the component could be removed without destroying or seriously damaging the host goods. Another was to ask whether the component had ceased to exist as a separate chattel. A third approach was to ask whether removal of the component would destroy the utility of the host goods.

¹¹⁵ That is, 'according to the ratio that the obligation secured by the perfected security interest bears to the sum of the obligations secured by all perfected security interests in the same [end product]': PPSA s 102.

¹¹⁶ As noted above, a security interest in the end product will be perfected if the collateral description in the original financing statement is sufficient to cover the end product as well as the secured party's inputs. If it is not, the secured party may register a financing change statement to amend the collateral description. The automatic perfection rule in s 100 does not apply because, as indicated in n 112, above, it applies only for the purposes of the default priority rules in s 55.

A fourth approach was to look at the intentions of the parties and the purpose of the attachment.¹¹⁷ Clearly, the outcome in Case 21 might vary, depending on which of these tests the court applied. In *Firestone Tire & Rubber Company of Canada Limited v Industrial Acceptance Corporation*,¹¹⁸ on which Example 21 is based, the Supreme Court of Canada opted for a version of the fourth approach, holding that if the accessions doctrine applied, SP1 would get a windfall in the form of an unbargained increase in the value of its collateral and this could not have been the parties' intention.

In an attempt to avoid the application of the accessions doctrine, a *Romalpa* supplier might include in the agreement a provision stipulating that the goods supplied should not be attached to other goods without the supplier's consent. However, while the buyer might be liable in damages for breach of a provision like this, the provision would not improve the supplier's priority position.¹¹⁹

(b) *The PPSA Position*

The PPSA changes the law in three main ways. First, it enacts a straightforward definition of 'accession' to replace the smorgasbord of common law tests; secondly, it contains a set of carefully thought out priority rules for resolving cases like Example 21; and thirdly, in cases where SP2 prevails over SP1, it gives SP2 a statutory right to remove the accession from the host goods.

The PPSA s 10 defines 'accession' to mean goods that are installed in or affixed to other goods.¹²⁰ This is considerably broader than the meaning of accession at common law under any of the competing tests described above. For example, the definition clearly covers tyres fixed to a truck, as in Example 21. The broader statutory definition is possible because, under the PPSA and in contrast to the common law, SP2 does not necessarily lose its collateral when it becomes an accession. At common law if a court decides that the accessions doctrine applies, that is the end of the matter. By contrast under the PPSA, a decision that the disputed collateral is an accession within the meaning of s 10 is only the first step. The next step is to identify the relevant priority rule and apply it to the facts.

¹¹⁷ The tests are discussed in *Firestone Tire & Rubber Company of Canada Limited v Industrial Acceptance Corporation* [1971] SCR 357.

¹¹⁸ [1971] SCR 357.

¹¹⁹ See McCormack, *Secured Credit*, above n 2, 192.

¹²⁰ Except if both the accession and the host goods are serial-numbered goods, for example aircraft and aircraft parts: PPSA s 10, 'serial number'; *Personal Property Securities Regulations 2010* (Cth), s 5.5, sch 1, cl 2.2.

The accessions priority rules are set out in ss 89–91. The rules vary depending on whether SP2’s security interest attached before or after its collateral (the tyres, in Example 21) became an accession. If SP2’s security interest attached beforehand, the basic rule is that SP2’s claim to the tyres has priority over SP1.¹²¹ On the other hand, if SP2’s security interest attached afterwards, SP1 has first claim to the tyres unless it consented to SP2’s security interest or disclaimed an interest in the tyres.¹²² Both rules are designed to give effect to the parties’ reasonable expectations. In the first case, the new tyres add to the value of SP1’s collateral (the truck) and SP1 would get a windfall if it could claim the tyres without paying for them. In the second case, since the new tyres are already on the truck at the time of SP1’s security agreement with Company, SP1 is likely to assume that they are part of its collateral and it will have negotiated with Company on that basis.

These basic priority rules do not depend on perfection of SP2’s security interest. However, once the accession has become affixed to the host goods, SP2 must register a financing statement, if it has not already done so, to be sure of protection against a third party who later acquires for value an interest in the host goods.¹²³

Example 22. SP1 has a security interest in Company’s truck, perfected by registration. SP2 supplies Company with new tyres on reservation of title terms and Company fits the tyres to the truck. Company later pays out SP1 and sells the truck to Buyer. Company defaults on payment to SP2 and SP2 claims the tyres from Buyer.

The success of SP2’s claim will depend on whether it registered a financing statement before Company sold the truck to Buyer: s 90(a). The purpose is to ensure that Buyer has notice of SP2’s security interest before she buys the truck but in this connection it is worth noting that there is no knowledge limitation in s 90: if SP2 fails to perfect, Buyer may claim the tyres even if, as it happens, she knew about SP2’s security interest.¹²⁴

The PPSA accessions priority rules are premised on the assumption that if SP2 prevails over SP1, it will have the right to remove the accession from the host goods. The rules governing SP2’s right of removal are in PPSA ss 92–95. In summary, the rules are as follows: (1) SP2 must first serve a notice on the grantor and also on any

¹²¹ PPSA s 89. SP1 may keep the tyres by paying out SP2: s 96.

¹²² PPSA s 91.

¹²³ PPSA ss 90, 91(b). Prior secured parties are also protected to the extent that they make advances after the accession occurs: s 90(c).

¹²⁴ There is a knowledge limitation in most of the Canadian PPSAs: see eg, Saskatchewan PPSA s 38. But see Ontario PPSA s 34 which has no knowledge limitation.

higher-ranking secured party;¹²⁵ (2) SP2 must avoid excessive damage to the host goods or undue inconvenience to the grantor when removing the accession; and (3) a person, other than the grantor, with an interest in the host goods may claim reimbursement for damage caused by removal of the accession.¹²⁶

V Conclusion

The PPSA is undoubtedly a novel and complex statute and the reader's first, or even second and subsequent, encounters with it may be a daunting experience. But perseverance pays dividends. Criticisms of the PPSA's complexity tend to overlook the complexity of the laws it replaces. Closer familiarity with the PPSA brings with it the realisation that in numerous significant respects, the statute simplifies the law. The statute's application to transactions known pre-PPSA as *Romalpa* agreements is no exception.

First, and perhaps most fundamentally, the PPSA avoids the formalism which was such a dominant feature of the previous law. So, for example, post-PPSA the legal characterisation of security interests is a thing of the past. Since the PPSA applies to every transaction that in substance creates a security interest, the difficult distinctions courts had to wrestle with in cases like *Associated Alloys* no longer matter. One consequence of the PPSA's substance over form approach is that all security interests, regardless of form, are subject to the registration system. There is, of course, a cost to registration but, in contrast to earlier registration statutes, the PPSA registration process is simple and relatively user-friendly, so that the registration requirement is hardly an onerous one. In any event, the benefit of a comprehensive registration system, in terms of the more effective publication of security interests, is impossible to deny.

Secondly, the PPSA puts the priority claims of *Romalpa* suppliers and the like on a more commercially rational basis. In common with the previous law, it gives super-priority status to purchase-money security interests but it conditions this outcome on procedural requirements aimed at giving existing secured creditors advance warning of the pmsi-holder's status so that they can adjust their future lending decisions as necessary. Thirdly, the PPSA

¹²⁵ The details of the notice are set out in s 95.

¹²⁶ PPSA s 93. Section 93 does not give the grantor itself any claim for reimbursement, but the grantor may have a damages claim under s 271 if SP2 breaches the obligation to avoid excessive damage in the course of removal. Section 95 provides that a person entitled to reimbursement under s 93 may refuse permission to remove the accession until SP2 has given adequate security for the reimbursement. Again, no corresponding right is given to the grantor. However, s 97 provides that, on the application of a person entitled to receive a notice under s 95, the court may make an order postponing the removal of the accession.

strengthens the pmsi-holder's position by giving it a statutory claim to proceeds; in the process, it addresses the policy concerns which underlay the pre-PPSA courts' hostility to proceeds claims. No less importantly, it also avoids the transaction costs and the litigation costs associated with the cat-and-mouse game played between drafters and the courts, where each increasingly complex decision promoted increasingly complex drafting efforts aimed at achieving the elusive desired result. The PPSA also strengthens the pmsi-holder's position in relation to commingled goods by giving it a statutory claim to the end product and enacting priority rules for competing claims to the end product. Once again, in the process, it sidesteps the complexities of the previous law as represented by *Borden* and later cases. Finally, the PPSA substantially simplifies the law governing accessions by: (1) enacting a bright-line definition of accession in place of the conflicting case law that previously applied; (2) substituting a coherent set of priority rules for competing accessions claims for the all or nothing approach of the common law accessions doctrine; and (3) creating a statutory right of removal by way of underpinning to reforms (1) and (2).

Of course, as others have noted, all these upsides for *Romalpa* suppliers must come at someone else's expense and typically that person will be the bank which is acting as the grantor's general lender.¹²⁷ However, for the reasons explained in Part II, above, in the bigger picture the PPSA's favourable treatment of pmsi-holders may not harm the general lender at all and may actually make it better off. Conversely, one might argue that the whole point of the reforms is to make the general lender worse off by countering its situational monopoly and giving competing financiers an opportunity to bid for at least part of the borrower's business. In any event, there are banks and banks. The new laws clearly benefit a bank which finances, say, a supplier of raw materials because they reduce the risk of non-payment by the supplier's customers and hence also the risk of the supplier defaulting against the bank.¹²⁸ In summary, as with all reforms there will be winners and losers and the market will adjust. But to the extent that the PPSA simplifies the law, it should lead to an overall reduction in the cost of credit and we can expect this benefit to flow through to the community at large.

¹²⁷ Brown and Sampson, above n 7, 109.

¹²⁸ *Ibid.*