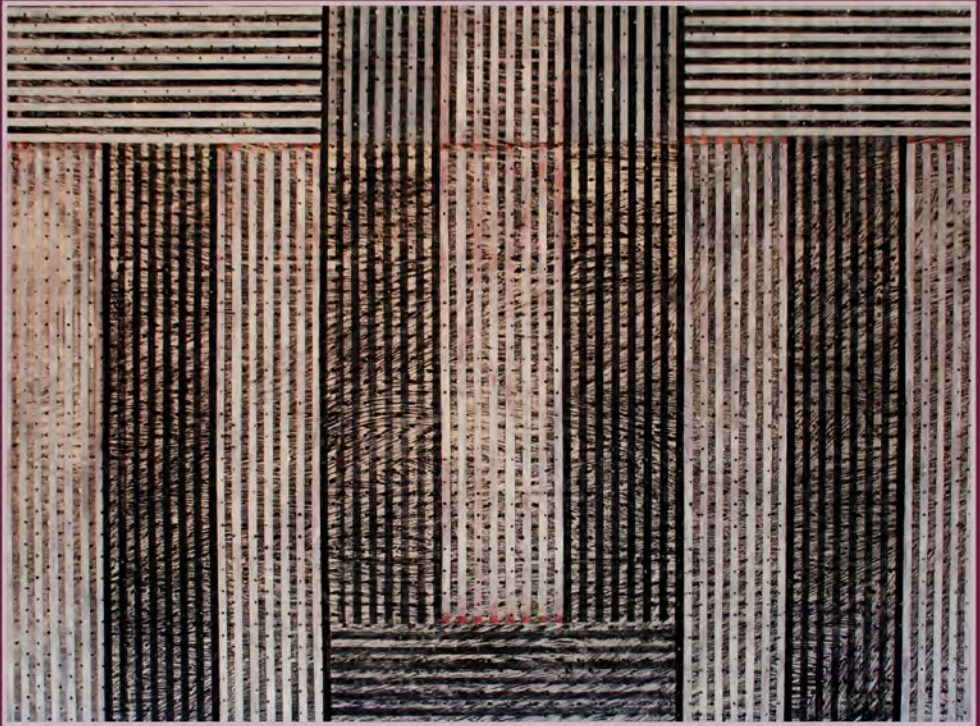


# The Law of Secured Credit



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THOMSON REUTERS

## FOREWORD

The provision of credit is the lifeblood of the economy. The law needs to facilitate it, by ensuring that transactions have the legal consequences the parties intend and the security that is granted by the debtor can be enforced when default occurs. When the worst happens and default leads to insolvency, another field of law opens up, with its own set of challenges. The law also needs to provide controls on lending practices, protection for vulnerable debtors, and certainty to others who deal with the debtor as creditors or transferees of property. To embark on a single publication that covers all of this territory, deals with security over both real and personal property and even encompasses more than one jurisdiction is a very ambitious project and a very onerous obligation. Mr Allan has set himself this task and this comprehensive, not to say extensive, publication is the result.

After the enactment of the Personal Property Securities Act 1999, the law of secured credit was very clearly divided between that relating to security interests in personal property and that relating to mortgages and other securities over real property. The publications in the field have tended to reflect this division. This work bucks the trend by dealing with them together.

Those of us involved in promoting the PPSA in the 1980s and 1990s envisaged that it would greatly simplify the law relating to security over personal property. The comparatively small number of cases in the 15 or so years since the PPSA came into force in New Zealand suggests we were not wrong. But seeing the extensive analysis spread over nine chapters of this work, grappling with some difficult issues of principle and practice, I now wonder whether the goal of simplicity was ever achievable, let alone achieved.

The text will be a convenient first port of call for issues relating to consumer credit, PPSA and real property security issues, insolvency and more for those who are engaged in transactions in this field, both those in law firms and those working directly for banks and financial institutions and for the agencies that regulate them. It will also be a reference point for students in insolvency, secured transactions and banking and finance subjects in their law degrees or commerce degrees, as well as academic lawyers specialising in those fields. Not only is there analysis of each of these areas of law, there are also comprehensive footnotes directing the reader to the relevant case law and other sources, not to mention comparative analysis with the relevant Australian law.

I am sure we judges will also have occasion to turn to the text for guidance. Hopefully, counsel will have already done so in formulating their arguments.

Hon Justice Mark O'Regan  
Supreme Court of New Zealand  
Wellington  
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## 12.1 The priority scheme

### 12.1.01 Function of priority rules

The idea of priority of a security interest is simple. It is the system of allocating priority in personal property which is complex. Where there is an item of personal property, and a number of creditors with security, the claim of the creditor with the highest priority will

be fully satisfied from that item before the creditor next in line receives anything. This process of satisfying the queue of creditors continues until the value of the property is exhausted. So the law of priority determines who misses out. The objective of the all-embracing substance-based approach is that all interests that are in reality giving security in personal property will be ranked according to this system. As a result, the Personal Property Securities Act 1999 (PPSA) also provides a comprehensive regime for the ranking of every interest which under the Act amounts to a security interest. The Canadian Supreme Court addressed this ranking system in *Bank of Montreal v Innovation Credit Union*.<sup>1</sup>

“The PPSA provides a detailed set of rules for resolving priority disputes between competing security interests; perfection and various temporal priority rules<sup>2</sup> generally serve as the default priority rules where there is no more specific rule that governs in a particular circumstance . . . . While having a security interest gives the secured creditor an interest which is enforceable both as against the debtor and against third parties, the PPSA recognizes other stakeholders’ interests in collateral by subordinating secured creditors’ interests to third parties’ interests in various circumstances. . . . Thus, within the domain of application of the Act, the PPSA provides a complete set of priority rules for ranking the interests of both creditors and third parties in particular property.”

The rules might in some cases seem arbitrary, artificial and possibly unfair in the way they operate in a specific set of circumstances, but the overriding objectives of the Act are to provide certainty and predictability.

Because it is comprehensive, the PPSA is only going to work if it is left to do its job without interruption: the temptations are strong to colour its interpretation by referencing how things were done before the PPSA became law, or to introduce common law, equitable or restitutionary principles. These temptations need to be resisted. In *KBA Canada Inc v 3S Printers Inc* the British Columbia Court of Appeal was asked to adjust the results obtained when the statutory priority rules were applied in order to give a more “equitable” result or to provide restitution, but it quite properly rejected both claims, saying:<sup>3</sup>

“It is well-established that the overriding goal of the PPSA is to provide commercial certainty and predictability to personal property financing. The statute includes clear rules for registration of financing statements in respect of security interests and for priorities among secured creditors. Courts have been very reluctant to circumvent or modify the explicit statutory provisions through the use of extra-statutory principles of common law or equity.”

1 *Bank of Montreal v Innovation Credit Union* 2010 SCC 47, [2010] 3 SCR 3, (2010) 325 DLR (4th) 605, 17 PPSAC (3d) 1 at [22]. By “PPSA” the Court means Canadian provincial personal property securities legislation [PPS legislation] generally (see at [17]).

2 Here the Court is referring to the Canadian equivalents of s 66 of the Personal Property Securities Act 1999 [PPSA] (or s 55 of the Personal Property Securities Act 2009 (Cth) [Australian PPSA]).

3 *KBA Canada Inc v 3S Printers Inc* 2014 BCCA 117, (2014) 59 BCLR (5th) 273, 372 DLR (4th) 303, 2 PPSAC (4th) 145 at [20] per Groberman JA.



The very point of the PPSA is to provide a set of rules which can provide for certain outcomes without getting bogged down in the “convoluted common law, equitable and statutory rules that beset personal property security law with complexity and uncertainty”.<sup>4</sup> Because s 66 of the PPSA (s 55 of the Personal Property Securities Act 2009 (Cth) (Australian PPSA)) provides a residual priority rule applicable whenever the Act does not provide another method for determining priority between competing secured parties, there is no “room for priorities to be determined on the basis of common law or equitable principles, except to the extent that those principles are expressly incorporated into the statutory scheme”.<sup>5</sup> Neither New Zealand nor Australia has given any precedence to the common law or equity in their respective personal property securities legislation (PPS legislation). Even in British Columbia, where the PPS legislation<sup>6</sup> does specifically preserve principles of the common law, equity and the law merchant (but only to the point that they are not inconsistent with the legislation), that did not open the door to alternative methods to determine priority. The general law can only be used to “fill interstices in the statute, or to cover areas that are beyond the scope of the legislation”.<sup>7</sup>

As for unjust enrichment, the Canadian approach requires an enrichment of the defendant, a corresponding deprivation of the plaintiff and an absence of juristic reason for the enrichment before restitution will be ordered.<sup>8</sup> The British Columbia Court of Appeal in *KBA Canada* accepted that the impact of the statutory priority rules is that there will normally be enrichment of one secured party at the expense of another,<sup>9</sup> so the focus was on whether the PPS legislation provided a juristic reason to not regard the enrichment as unjust. After noting that a statutory disposition of property rights provides a juristic reason,<sup>10</sup> and that if a statute only addresses enrichment obliquely there might not be a clear statutory disposition, Groberman JA held that the PPS legislation comprehensively governs priority among creditors, so that there is a clear statutory disposition, and thus unjust enrichment could not be used to navigate around the clear statutory provisions.<sup>11</sup>

Although the test for unjust enrichment might not always be articulated in the same way in every jurisdiction, whatever test is used needs to respond to the central importance of letting the statute do its job.

In addition to resolving priority conflicts between various secured parties, the PPSA also provides some rules to give priority to interests arising outside the Act. Furthermore,

4 *KBA Canada Inc v 3S Printers Inc* 2014 BCCA 117, (2014) 59 BCLR (5th) 273, 372 DLR (4th) 303, 2 PPSAC (4th) 145 at [21], citing *674921 BC Ltd v Advanced Wing Technologies Corp* 2006 BCCA 49, (2006) 50 BCLR (4th) 201, 263 DLR (4th) 290, 9 PPSAC (3d) 43 at [1] per Newbury JA.

5 *KBA Canada Inc v 3S Printers Inc* 2014 BCCA 117, (2014) 59 BCLR (5th) 273, 372 DLR (4th) 303, 2 PPSAC (4th) 145 at [22] per Groberman JA.

6 Personal Property Security Act RSBC 1996 c 359.

7 *KBA Canada Inc v 3S Printers Inc* 2014 BCCA 117, (2014) 59 BCLR (5th) 273, 372 DLR (4th) 303, 2 PPSAC (4th) 145 at [26].

8 *Garland v Consumers' Gas Co* 2004 SCC 25, [2004] 1 SCR 629, (2004) 237 DLR (4th) 385.

9 This had occurred here because the plaintiff's registration was cancelled by accident, which meant it lost priority to the defendant.

10 Citing *Gladstone v Canada (Attorney General)* 2005 SCC 21, [2005] 1 SCR 325, (2005) 251 DLR (4th) 1.

11 *KBA Canada Inc v 3S Printers Inc* 2014 BCCA 117, (2014) 59 BCLR (5th) 273, 372 DLR (4th) 303, 2 PPSAC (4th) 145 at [42].

some external statutes which create interests in personal property provide rules for how those interests rank in competition with security interests. For example, s 169 of the Tax Administration Act 1994 provides a rubric for ranking the charge that the Commissioner of Inland Revenue has against a debtor's property in respect of unpaid taxes and accident compensation levies. A further example is the priority given to preferential creditors by s 312 and sch 7 of the Companies Act 1993.

A secured party with a particular priority level can, as a result of s 72 of the PPSA (s 58 of the Australian PPSA), enjoy the same priority for all future advances. Its security will also normally attach to after-acquired property under s 43 (s 18(2) of the Australian PPSA), so long as the security agreement provides for it. If its collateral is dealt with by the debtor in a way which produces some form of substitute personal property, then s 45 (s 32 of the Australian PPSA) allows its security interest to continue into those proceeds. When it comes to after-acquired property and proceeds, it cannot be said that the secured party with a particular security interest will have the same priority across the board, because it will normally come into conflict with other secured parties, each with their own priority positions. What can be said is that the secured party's priority when it comes to proceeds is determined by the same factors as determine the priority of the security interest in the original collateral. For example, if the financing statement was registered on a particular date, the same registration date will determine the priority for both the collateral and its proceeds; and if there was a purchase money security interest in the collateral, the same will be the case for its proceeds. These conflicts will need to be resolved in the individual factual circumstances, but by applying the priority rules established by the PPSA.

This chapter outlines the general priority scheme and examines the relative priority of the purchase money security interest, the assignee of accounts receivable for new value, and the preferential creditors. These are the parties whose interests are most likely to come into conflict with each other. It also considers how the statutory priority rules might be altered by agreement and concludes with a discussion of proceeds. Proceeds are included in this chapter because it is impossible to determine the extent of a secured party's claim without an understanding of their nature and the way in which they extend the reach of a security interest.

This chapter does not provide an account of all priority rules: chapter 13 deals with the more specific ones. Some of the specific rules are applied relatively frequently, such as the priority in relation to commingled goods (which is touched upon in this chapter in discussing the purchase money security interest) and the protection given to buyers of collateral subject to security interests sold in the ordinary course of business of the seller. Others are more obscure, arising relatively rarely. Between these two chapters, a complete account of the priority engine that is the PPSA will be given.

### 12.1.02 Overview of scheme

By way of a general overview, s 66(a) of the PPSA (s 55(3) of the Australian PPSA) sets up a priority regime which creates a dichotomy between unperfected security interests and perfected security interests. All perfected security interests rank ahead of all unperfected security interests, which in turn rank ahead of all unsecured creditors.<sup>12</sup> Under these default rules, the priority of secured creditors is then determined strictly in



accordance with their priority dates, i.e. when they perfected their securities (this is not when they each obtained a perfected security, but when they took the step that qualified as perfection). The priority of unperfected securities is determined by the order in which they attached. If there is anything left, it is shared out among the unsecured creditors on a pro rata basis, which is an application of the law of company liquidations or personal bankruptcy rather than the PPSA. A creditor with a security interest which has not attached is in law an unsecured creditor and will rank with all other unsecured creditors.

While s 66 sets up a relatively simple ranking scheme that could be comprehensive, it does not purport to provide a complete system of priorities. It only applies in the absence of some other way of determining priority established by the PPSA.<sup>13</sup> This is because there are interests and transactions which are seen as meriting special treatment, so that they are given a specific priority rule. The effect might be to give the creditor a security interest that outranks any priority given by s 66, such as the purchase money security interest (PMSI). In Australia, s 57 of the Australian PPSA gives highest priority of all to security interests perfected by control.<sup>14</sup> Other priority rules might determine specific priority contests, as s 75A of the PPSA (s 64 of the Australian PPSA) does where there is a competition between an inventory supplier making a proceeds claim to accounts receivable and a purchaser of those accounts receivable.

Then there are a number of provisions which are variations on the theme of protecting the good faith purchaser for value. There are specific rules in ss 94–99 dealing with the purchasers of documentary intangibles, and then the more general ones in ss 52–58.<sup>15</sup>

In assessing the priority given to a security interest, the ranking it is given by the PPSA is not the only important factor. The extent to which a creditor can enjoy that priority (i.e. how much of the obligation owed to it has the same priority) is also vital. So long as appropriate provision is made for it in the security agreement, s 72 (s 58 of the Australian PPSA) means that a creditor can enjoy the same priority for all future advances. This is very different from the situation in equity, where a secured party which becomes aware of a subsequent security interest and then makes further advances is subordinated to that second security-holder.<sup>16</sup> It is also different from the protection given to real property mortgagees for future advances.<sup>17</sup>

In broad terms, a creditor which is first in priority pursuant to s 66 (s 55 of the Australian PPSA) can enjoy the same priority over all personal property, present and future, in which the debtor has an interest, if it describes its collateral appropriately.<sup>18</sup>

12 This is not the case in Australia: for the status of an unperfected security interest in Australia when the debtor is insolvent, see [12.2.03].

13 Section 55(1) of the Australian PPSA also makes this explicit by saying that the section sets out the rules for determining priority between competing security interests “if this Act provides no other way of determining that priority”.

14 See [9.6.02] for perfection by control and [12.6] for an account of this priority rule.

15 Part 2.5 of the Australian PPSA provides for situations when personal property can be taken free of security interests.

16 This is the rule in *Hopkinson v Rolt* (1861) 9 HLC 514, 11 ER 829 (HL), which is considered at [11.2.02].

17 This protection is provided by ss 90–94 of the Property Law Act 2007: see [11.2.03].

18 Section 43 of the PPSA (s 18(2) of the Australian PPSA) allows a security agreement to include after-acquired property, and s 44 (s 18(3) of the Australian PPSA) governs how a security interest will attach to such property, as discussed further at [8.3.02(8)–(10)].

This is a generalisation, however, as particular items of personal property may become subject to one of the rules which override the s 66 ranking system.

The creditor is also often given the same priority it has in its collateral over the proceeds of that collateral. This is of particular advantage if the creditor has a PMSI, as its proceeds claim will then be superior in priority to any creditor relying on s 66 for its priority. The extent to which a creditor might have a proceeds claim is considered in [12.8].

The typical context in which these priorities are applied is where the debtor is insolvent. Most frequently, the creditor with first priority according to s 66 is the debtor's bank or other lender with an all-embracing general security agreement (GSA).<sup>19</sup> To a large extent the other claims are thus making inroads against what will be available to the bank. The major players can often be grouped into suppliers, accounts receivable financiers (including factors), tax authorities and employees (the latter two by way of the preferential creditor regime). The debtor's bank, however, is in quite a privileged position. Although it faces claims from suppliers asserting PMSI proceeds claims, at the same time the bank may well be able to fight back with an even better claim, as purchaser of all funds, in whatever form, deposited with it by the debtor. This was how the bank in *Flexi-Coil Ltd v Kindersley District Credit Union Ltd* succeeded in its contest with the suppliers.<sup>20</sup> Furthermore, insofar as a bank relies upon a right of set-off or combination of accounts, s 23(c) (s 8(1)(d) of the Australian PPSA) means that the PPSA will not interrupt that right.

### 12.1.03 Time for determining priority

There is one shortcoming to the priority scheme, namely there is no rule for saying when priority is to be assessed. If a creditor decides to enforce its rights against collateral, will its priority be affected by post-enforcement perfection steps taken by another creditor? For example, if a creditor appoints a receiver or takes possession, does that freeze priorities at that date? This can become important if the creditor's registration lapses, so that it no longer has a perfected security interest. It can also be important in the context of liquidations, where the liquidator will be obliged to pay out in accordance with the statutory scheme of priority. Will the liquidator need to respect the status of a creditor which perfects a security interest after the debtor is in liquidation?

Although there are strong policy arguments for saying that there is a need for a fixed date for assessing priority, no such date is given by the legislation. In *Sperry Inc v Canadian Imperial Bank of Commerce* the registration of two secured parties had lapsed, so they were both unperfected.<sup>21</sup> One (the bank) appointed a receiver, and the other subsequently registered a financing statement and claimed that the registration gave it priority over the bank. The Ontario Court of Appeal held that the bank's acts of appointing a receiver and realising the assets could not be relied on as perfection, because the receiver had been

19 Before the PPSA came into force, a creditor wishing to maximise its security would normally take a debenture, which provided for a mixture of fixed and floating charges. While some creditors might still call their security agreement a debenture, "general security agreement" is to be preferred.

20 *Flexi-Coil Ltd v Kindersley District Credit Union Ltd* (1993) 113 Sask R 298, 107 DLR (4th) 129, 5 PPSAC (2d) 192 (SKCA).

21 *Sperry Inc v Canadian Imperial Bank of Commerce* (1985) 50 OR (2d) 267, 17 DLR (4th) 236, 4 PPSAC 314 (ONCA).

appointed as agent for the debtor and any possession by the bank would have been by way of enforcement. The priority conflict was ultimately concluded by the equivalent of s 66(c) of the PPSA: as both security interests were unperfected, the order of attachment favoured the other secured party. This meant that there was no need to decide whether that creditor's registration after receivership gave it priority over the bank, but Morden JA suggested (without any discussion) that priority issues between parties should be resolved as at the time their respective security interests come into conflict.<sup>22</sup> This will be either when a creditor attempts to enforce its security or when the debtor goes into liquidation or becomes bankrupt. Several Canadian cases have subsequently adopted this approach, albeit without any analysis of its correctness.<sup>23</sup> One consequence is that if a creditor with a perfected security interest attempts to enforce it, such as by appointing a receiver, and the perfection subsequently lapses, that should not diminish the creditor's priority.<sup>24</sup>

This point arose in *Gibbston Downs Wines Ltd v Perpetual Trust Ltd*.<sup>25</sup> Two creditors had perfected their security interests by registering financing statements, but they reached an agreement under which the senior (i.e. first-registered) creditor agreed to subordinate its priority to that of the junior creditor, and it filed a financing change statement. That disclosed that the subordination agreement would expire on a particular date. Before this date, the junior creditor placed the debtor in receivership and argued that the date of doing so was the date of determining priority, so that it could not be affected by any expiry of the subordination agreement. Although the High Court held that the subordination agreement did not expire on the date disclosed in the financing change statement, Chisholm J said that, if it had been required, he would have held that the competing priorities fell to be determined when the receiver was appointed.<sup>26</sup> It was "logical and in accord with principle" to employ the time at which the competing interests came into conflict to fix priorities.<sup>27</sup> His Honour commented that this conflict will not always coincide with the appointment of a receiver, as the point at which security interests conflict depends on all the circumstances, particularly the terms of the security agreements of the competing creditors.<sup>28</sup>

This last comment has been criticised, as it introduces uncertainty as to when the conflict crystallising priorities arises, given that it will not necessarily be upon a formal insolvency

22 *Sperry Inc v Canadian Imperial Bank of Commerce* (1985) 50 OR (2d) 267, 17 DLR (4th) 236, 4 PPSAC 314 (ONCA) at [37].

23 *Loeb Canada Inc v Caisse Populaire Alexandria Ltée* (2004) 7 PPSAC (3d) 194 (ONSCJ); *Textron Financial Canada Ltd v Beta Brands Ltd* (2007) 12 PPSAC (3d) 46 (ONSCJ); and *Jacobs v Laumaillet* 2010 BCSC 1229, (2010) 17 PPSAC (3d) 272.

24 This was the factual position in *Re 1231640 Ontario Inc* 2007 ONCA 810, (2007) 289 DLR (4th) 684, 13 PPSAC (3d) 57. Unfortunately for the creditor which had appointed the receiver, the debtor then went into bankruptcy, and the effect of s 20 of the Personal Property Security Act RSO 1990 c P.10 was that the security, being unperfected at the time of bankruptcy, was not effective against the trustee in bankruptcy.

25 *Gibbston Downs Wines Ltd v Perpetual Trust Ltd* [2012] NZHC 1022, [2012] 2 NZLR 574.

26 *Gibbston Downs Wines Ltd v Perpetual Trust Ltd* [2012] NZHC 1022, [2012] 2 NZLR 574 at [43].

27 *Gibbston Downs Wines Ltd v Perpetual Trust Ltd* [2012] NZHC 1022, [2012] 2 NZLR 574 at [48]. The Court of Appeal said that determining priority at the date of receivership, at least in this case, had "much to commend it in the particular circumstances applicable here": *Gibbston Downs Wines Ltd v Perpetual Trust Ltd* [2013] NZCA 506, [2014] NZCCLR 6 at [70].

28 *Gibbston Downs Wines Ltd v Perpetual Trust Ltd* [2012] NZHC 1022, [2012] 2 NZLR 574 at [48].

event. This might be as soon as there are insufficient assets to meet conflicting security interests, which would raise questions as to the consequences of that insufficiency being remedied.<sup>29</sup> None of the Canadian cases have accepted that such an abstract or potential conflict between secured parties will suffice to fix the time for assessing priority: there must be an actual conflict, triggered by a creditor taking some form of enforcement, such as taking possession of the collateral. The taking of preparatory steps by a creditor, such as asserting its claims, or steps to protect its position short of direct enforcement against the collateral, are not sufficient.<sup>30</sup> If this approach is followed in New Zealand, concerns about uncertainty will abate.

The appointment of a receiver has been described as an “ambiguous” step, because it will not necessarily mean that the interests of creditors are in conflict.<sup>31</sup> Most receivers are appointed by secured parties but as agent for the debtor. Although this means that the secured party has not actually taken possession, such an appointment is a clear step in the enforcement of a security and, at least where the debtor is insolvent, triggers conflicts with other security interests. The Canadian procedure for appointing receivers is different to that in New Zealand and there is no consistent approach taken to whether receivership determines priority.<sup>32</sup>

## 12.2 The default priority rules

Because all of the other priority rules work against the background, and interrupt the operation, of the default or residual priority rules established by s 66 of the PPSA (s 55 of the Australian PPSA), it is useful to consider them first. They apply only if the Act provides no other way to determine priority between security interests in the same collateral. To have a security interest in collateral, a creditor’s security interest must have attached in accordance with the mechanism established in s 40, which is discussed in chapter 8. The security interest also needs to meet the s 36 requirements if it is to be enforced against another secured party or a third party which has taken an interest in the collateral, such as a buyer or lessee. If the security interest has not attached or is not enforceable, the creditor is unsecured and has no priority. Its only option would be to prove its debt along with other unsecured creditors.

While there are several ways in which creditors are given a better priority than s 66 would give them, this does not actually affect the operation of s 66. Their effect is generally on the creditor given the best priority by s 66, and to reduce the value available for distribution down the chain of priorities established by 66.

29 Michael Gedye and Steve Flynn *Personal Property Securities Act: Recent Developments you Need to Know About* (ADLS, Auckland, 2013).

30 In *Loeb Canada Inc v Caisse Populaire Alexandria Ltée* (2004) 7 PPSAC (3d) 194 (ONSCJ) the Ontario Superior Court of Justice rejected any earlier dates, even though the Court had appointed an interim receiver and the debtor was petitioned into bankruptcy.

31 Paul Heath and Michael Whale (eds) *Heath and Whale on Insolvency* (online looseleaf ed, LexisNexis) at [25.11].

32 The appointment of a receiver was seen as sufficient to create the necessary conflict in *Spery Inc v Canadian Imperial Bank of Commerce* (1985) 50 OR (2d) 267, 17 DLR (4th) 236, 4 PPSAC 314 (ONCA) and *Canadian Imperial Bank of Commerce v Melnitzer* (1993) 6 PPSAC (2d) 5 (ONCJ). Compare *Loeb Canada Inc v Caisse Populaire Alexandria Ltée* (2004) 7 PPSAC (3d) 194 (ONSCJ) and *Textron Financial Canada Ltd v Beta Brands Ltd* (2007) 12 PPSAC (3d) 46 (ONSCJ), which both held that the date of appointment of a receiver was not the date on which priorities were to be determined.

## 12.2.01 Perfected security interests

The policy which underpins s 66 of the PPSA is that perfection is to be encouraged, by giving the most favourable treatment to the creditor that perfects first. This is irrespective of whether the creditor is aware of unperfected security interests. The Ontario Court of Justice (Jarvis J) said in *BMP & Daughters Investment Corp v 941242 Ontario Ltd*:<sup>33</sup>

“There is merit in having a clear-cut rule of priority. Parties will perfect promptly in order to ensure that the ‘greatest bundle of rights’ has been secured. Accordingly, where a secured party hesitates or fails to perfect, then he runs the risk of subordination to later and more diligent secured interests. In short, the integrity of the PPSA must be maintained at the expense of the equitable doctrine of actual notice.”

Although the concern is with perfected security interests, the ranking is not in accordance with when a creditor’s security interest became perfected. The effect of s 66(b) of the PPSA is that priority is determined by the order in which the competing creditors took the step they rely upon as perfection.<sup>34</sup> The three recognised steps, or acts of perfection, are the registration of a financing statement, the taking of possession in accordance with s 41, or the commencement of a period of temporary perfection. There is one omission, in that s 50 provides for perfection by way of a bailee issuing a document of title in the name of the creditor, but this is not mentioned in s 66. These steps are all discussed further in chapter 9.

This step (or time in Australia) can precede attachment of the security interest, as s 41(2) (s 21(3) of the Australian PPSA) does not care which happens first, so long as both have happened at the time at which a creditor is relying upon its security interest. In addition, s 146 confirms that a financing statement can be registered before a security agreement is even entered. So it is the priority date which is important – this is not a term used in the Act, but it is useful to describe the time of the earliest act of perfection upon which the creditor can rely.

Here the rules about continuous perfection become important, because so long as the creditor’s perfection has been continuous,<sup>35</sup> its priority date for the purposes of s 66(b) is the first act of perfection in a chain of perfections. So there may have been a period of temporary perfection, within which the creditor took possession of the collateral, and then, before losing possession, it filed a financing statement. By s 42 (s 56 of the Australian PPSA) the perfection will be continuous and the creditor’s priority date will be

33 *BMP & Daughters Investment Corp v 941242 Ontario Ltd* (1992) 11 OR (3d) 81, 96 DLR (4th) 741, 4 PPSAC (2d) 220 (ONCJ) at [19].

34 Section 55(4) of the Australian PPSA states that priority between competing security interests “that are currently perfected” is determined by the order in which the “priority time” for each security interest occurs. For each security interest, its priority time is defined in s 55(5) as being the earliest of one of three “times” to occur: its registration time, the time at which the creditor (or someone on its behalf) took possession, or the time at which the security is temporarily perfected “or otherwise perfected” by force of the Act. Perfection of goods in the hands of a bailee under s 22 means that the security is otherwise perfected by force of the Act.

35 Section 55(6) of the Australian PPSA states that a time will only be a priority time if, once a security interest is perfected, it remains continuously perfected.



when the period of temporary perfection started. The method of perfection plays a limited part in the priority given, but s 67 provides that a continuously perfected security interest is to be treated as perfected by the method of the original perfection. This can be important where there are rules that apply to particular types of perfection, such as in the context of the priority rules dealing with transferred collateral. What is clear is that the register will not provide an accurate record of the priority date of a creditor's security interest, as that can be made earlier than the date of registration by the application of these rules.

Any gap leading to discontinuous perfection will break the chain, and the priority date will be when the creditor next perfects. If it fails to, then the security is, of course, unperfected.

So, once the priority date of the various creditors is established, where the competition is between creditors with security interests in the same collateral who rely solely upon s 66, they are to be ranked in order of their priority date. The claims of the first-ranked creditor may include all obligations of the debtor to that creditor, if the security agreement is appropriately worded. This claim may switch from the original collateral to proceeds of that collateral, so long as the financing statement has an appropriate description to allow continuous perfection.

If there is any residual value in the collateral after the claims of the first-ranked creditor are met, then those of the second-ranked creditor are to be met and so on down the chain, until the claims of all creditors with perfected security are met or the value of the collateral is exhausted.

### 12.2.02 Unperfected security interests

If there is still a residue, attention shifts to the claims of those creditors with an attached but unperfected security interest. New Zealand is anomalous in that an unperfected security interest remains valid and enforceable in the event of the debtor going into liquidation or bankruptcy. Under s 66(c) of the PPSA, creditors with unperfected security interests are to be ranked in order of attachment – which will require consideration of when the creditor gave value, when the debtor acquired rights in the collateral (this will generally be the same date for all creditors), and when an enforceable security agreement arose under s 36. All three must be present to amount to an attached security interest, but the order in which they happen is not important.

An unperfected security interest is subject to the same host of overriding interests as a perfected security is but, in addition, is always going to lose out to a buyer or lessee of collateral under s 52, so long as they provide value.<sup>36</sup> Obviously, if the buyer or lessee has given the unperfected security interest, they cannot then rely on the lack of perfection to avoid it. The significance of s 52 is that factors which might prevent a buyer of collateral from gaining ascendancy over a creditor with a perfected security interest in the collateral will not affect the buyer as against the holder of an unperfected security. For example, under s 52 the buyer need not be a good faith buyer, or it may have a level of knowledge of the security interest or agreement which would prevent the purchase from prevailing over a perfected security interest. In this the PPSA differs from revised § 9-317 of the

36 See [13.6.01].



Uniform Commercial Code and Canadian PPS legislation. Creditors facing a loss under s 52 of the PPSA cannot finesse the buyer by claiming that the buyer is exercising a right under the PPSA and so owes a duty of good faith under s 25 which it cannot meet if it has knowledge of the security interest. Under s 25(2), knowledge of an interest is not to be equated with bad faith.

A buyer in this context needs to be seen as a buyer in Sale of Goods Act 1908 terms, and is not to be equated with a “purchaser” as defined in s 16(1) of the PPSA (which is wide enough to include creditors taking a security interest). Where the collateral is goods, it is simple to decide if the person relying upon s 52 is a buyer, but the question becomes more complex when it comes to other forms of collateral, particularly those which are not traditionally regarded as being bought or sold.

In addition, an unsecured judgment creditor which is using judicial processes to execute its judgment against collateral is given priority by s 103 over a creditor which has an unperfected security interest at the time of the execution. This will be when the judgment creditor has the goods seized, or has either a garnishee or charging order made.

Any residue left when the claims of holders of unperfected security interests have been met is then distributed in accordance with the pro rata sharing regime of bankruptcy or liquidation law.

### 12.2.03 Unperfected security interests in Australia

The Australian PPSA has some similarities to the New Zealand Act: s 55(2) determines priority of unperfected security interests in accordance with the order of attachment, and s 43 allows every buyer or lessee for value to take personal property free of unperfected security interests (with the same exception for security interests given by the buyer or lessee). Section 74 is in almost exactly the same terms as s 103 of the New Zealand Act, except to make it clear that the judgment creditor retains its priority even if a secured party subsequently perfects its security.

One major philosophical and practical difference is the effect that insolvency has upon an unperfected security. In New Zealand the security will remain effective as against unsecured creditors. The approach taken in Canada is to provide that the security is to be not effective against a trustee in bankruptcy. As is discussed at [5.4.04], this has created difficult questions concerning the location of title. While it does not matter for the purposes of the PPSA whether the debtor or creditor (and, to some extent, a third party) has title, bankruptcy law generally only vests the property of a debtor in the debtor's trustee or assignee. This led the Supreme Court of Canada in *Re Giffen* to hold that a statutory security interest gives title to the debtor.<sup>37</sup> This decision was necessary to ensure that the creditor, which had not perfected its security interest, could not rely on a claim of title when the debtor became bankrupt. That would have contradicted the rules in British Columbian PPS legislation that the creditor's security interest was not to be effective and that title cannot be relied on as a form of security. Problematically, in a different context, the Canadian Supreme Court in *Royal Bank of Canada v Sparrow Electric Corp* held that the secured party has title, at least if it has perfected its security, to defeat a statutory lien of the debtor's property.<sup>38</sup>

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37 *Re Giffen* [1998] 1 SCR 91, (1998) 155 DLR (4th) 332, 13 PPSAC (2d) 255.

(1) *Unperfected security interests vest in grantor*

These cases provide an important context for understanding the provisions in the Australian PPSA for dealing with the consequences of insolvency upon a creditor with an unperfected security interest. The primary rule is set out in s 267: it applies whenever a debtor is subject to winding up, administration, a deed of company arrangement, sequestration or bankruptcy. These might be summarised as an insolvency event. A timing rule is provided by s 267(1)(b) – which is essentially the commencement of a bankruptcy or winding up, or when a sequestration order is made, or whenever a period of administration or deed of company arrangement begins. This will depend on the relevant provisions of the Corporations Act 2001 (Cth) and the Bankruptcy Act 1966 (Cth) – the intent is to define a specific time at which s 267 is to operate.

At that time, any creditor with an unperfected security interest loses its status as a secured party unless an exception under s 268 of the Australian PPSA arises. This is done by s 267(2): the security interest of a creditor with an unperfected security “vests” in the grantor. While this vesting is triggered by the insolvency event defined in s 267(1)(a), it is deemed to have happened “immediately before” the insolvency event: this is necessary to make it clear that the unperfected security does not survive the insolvency event. The consequence is that any interest the secured party might have had is transferred to the debtor and can thus be distributed to the unsecured creditors (subject to the claims of other secured parties which have perfected).

A secondary rule is established by s 267A to deal with situations where the debtor has agreed to grant a security but, before it attaches, one of the insolvency events described in s 267(1)(a) intervenes. So long as the creditor never perfects, the general effect of s 267A is to vest its security interest in the debtor when it attaches to the collateral (unless a s 268 exception arises). For example, a debtor might have entered into a long-term supply agreement under which the supplier is granted a security interest in goods to be supplied. The security interest will not normally attach to particular goods until they are delivered to the debtor. If an order for winding up the debtor is made and the supplier then delivers goods to the debtor, the supplier’s status will depend upon s 267A. Obviously, the supplier might have already perfected this security by registering a financing statement which covers the particular collateral, and so long as it has done so before the winding up order is made, it will not be affected by s 267A. Creditors that have not perfected by registration at the time of an insolvency event (called the “critical time” in s 267A(1)(b)) stand to lose their security interest in respect of all collateral to which the security interest attaches after the critical time.

Not every creditor will lose an unperfected security, however. The effect of s 267A(1)(e) is to vest the security interest in the debtor when it attaches to the collateral, but only if at that time the security interest is either still not perfected or was perfected by registration after the critical time. For example, if a supplier of goods becomes aware that the debtor is in liquidation, registers a financing statement and then delivers goods, that registration will not assist the supplier. This leaves open the possibility of perfection by

38 *Royal Bank of Canada v Sparrow Electric Corp* [1997] 1 SCR 411, (1997) 143 DLR (4th) 385, 12 PPSAC (2d) 68.

some other means, such as by taking possession or by control, being effective to prevent the operation of s 267A.

Where a creditor loses its security as a result of either of these rules, it will become an unsecured creditor and be entitled to file a proof of debt in the normal way. One problem which arises is that some creditors will lose more than the status of a secured creditor. For example, a creditor might have leased goods to the debtor: when its security interest in those goods vests in the debtor, the creditor will lose the entire value of the goods. The effect of s 269 is to allow the creditor to be an unsecured creditor for the value of the goods, although its operation is confined to lessors, bailors and commercial consignors of goods. Creditors of these types are deemed by s 269(2) to have suffered damage immediately before their security interest vests in the debtor, which is what gives rise to the ability to file a proof of debt.

The quantum of this loss is determined by s 269(3), which provides two measures of damages. One is the actual market value of the goods involved, together with any other losses which arise from the termination of the lease, bailment or consignment in question. The other looks to the terms of the lease, bailment or consignment: if the creditor has provided a mechanism for determining the loss, then that mechanism can be applied to determine the creditor's recoverable loss. The two measures might lead to different results: s 269(3) allows the creditor to claim against the debtor for the greater of the two. Obviously, this claim will be as an unsecured creditor.

## (2) *Exceptions*

The vesting rules in ss 267 and 267A of the Australian PPSA do not apply to every unperfected security interest. Three classes of exceptions are created by s 268. The first relates to interests deemed to be security interests by s 12(3), i.e. transfers of accounts and chattel paper, commercial consignments, and PPS leases.<sup>39</sup> It is possible that a transaction of one of these types does not secure any obligation. For example, accounts or chattel paper might be sold outright; or goods might be subject to a genuine lease, where all the nominal debtor is required to do is pay for the right to possess the goods. So long as a security interest is provided for by a transfer of an account or chattel paper or by a commercial consignment but the deemed security interest does not actually secure an obligation, then s 268(1)(a) means that the creditor will not be affected by a lack of perfection.

The situation with PPS leases is a little more complicated, as s 268(1)(a)(ii) only creates an exception to ss 267 and 267A for a lease described by s 13(1)(e), i.e. a lease or bailment of serial-numbered goods for 90 days or more, but only if the lease does not also fit into s 13(1)(a)–(d), i.e. a lease or bailment for more than a year. A qualifying lease will be excepted from the operation of ss 267 and 267A if it does not secure an obligation.

The second class is comprised of foreign security interests, where the rules for perfection and for the consequences of perfection and non-perfection are governed by the law of a foreign jurisdiction at the time of the insolvency event. New Zealand creditors might benefit from this: if their security interests with an Australian debtor are governed by

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39 The meaning of "PPS lease" is discussed at [5.5.03].

New Zealand law at the relevant time, then a lack of perfection will be dealt with by New Zealand law. Obviously, they will still be subject to the normal priority rules, but they will at least avoid the vesting rule.

The third class involves a particular form of subordinated debt known as a turnover trust. It is specified at length in s 268(2), and all elements must be satisfied for the exception to arise. In essence, it requires an agreement between a junior and senior creditor of a common debtor (called the “obligor” in s 268(2)(a)), under which they agree that the junior creditor’s debt is subordinated to that of the senior creditor. More particularly, the agreement must also provide that if the debtor transfers any personal property to the junior creditor while the debtor is still indebted to the senior creditor, the junior creditor will transfer that property or its proceeds to the senior creditor. The agreement must also provide that if the junior creditor does not transfer the property or proceeds, the junior creditor is to hold the property or its proceeds on trust for the senior creditor and to grant a security interest to the senior creditor. If all of these elements are satisfied, the security interest so granted will not need to be perfected to avoid the operation of ss 267 and 267A.<sup>40</sup>

The Corporations Act 2001 (Cth) also makes provision for the consequences of a security interest not being perfected when a company is being wound up, in administration or subject to a deed of company arrangement. The primary rule is that the interest of a creditor with an unperfected security interest vests under s 588FL of the Corporations Act in the company, unless excluded by s 588FN. One significant difference between these provisions and their equivalents in the Australian PPSA is that s 588FM of the Corporations Act allows the court to extend the time for registration. This means that even if a security interest is unperfected at the critical time, the creditor can salvage the situation by a subsequent registration. The operation of the Corporations Act in this context is considered in [17.9.01].

### (3) *Third parties*

The operation of the vesting rules in ss 267 and 267A of the Australian PPSA has the obvious potential to undermine transactions in which an unperfected creditor has exercised rights arising under its security to deal with any collateral subject to the security. If the creditor is stripped of its interest in that collateral, this would normally invalidate the transaction.

To protect third parties, s 267(3) deems their title to not be affected by the operation of s 267(2), so long as they have acquired the personal property for “new value” and have neither actual nor constructive notice of certain specified steps preliminary to an insolvency event.<sup>41</sup> The protection is only available to third parties acquiring assets of a company debtor, and will arise when the third party has acquired the property from the creditor itself, someone acting on its behalf or a receiver exercising his or her powers.

Identical provision is made in s 267A(2) to protect third parties where a creditor’s security interest is vested in the debtor in accordance with s 267A(1).

40 As is discussed at [12.7.03(3)], in New Zealand s 17A of the PPSA provides that trusts of this type are not security interests if the debtor is in liquidation or bankrupt.

41 These are the filing of an application to wind up the debtor company or the passing of a resolution to do so, the appointment of an administrator, or the execution of a deed of company arrangement.

## 12.3 The purchase money security interest

### 12.3.01 Commercial importance of the PMSI

Since the 19th century it has been accepted that a business enterprise is able to commit all of its future property to a particular secured party.<sup>42</sup> The ability to charge after-acquired property is stated expressly in s 43 of the PPSA (s 18(2) of the Australian PPSA) and can be achieved without any specific act of appropriation. Furthermore, s 72 (s 58 of the Australian PPSA) allows all advances, including further advances, to enjoy the same priority. This creates the potential for the first creditor to perfect to always have first priority on all personal property for all obligations, but this would create an enormous practical problem for debtors.

Many potential suppliers of credit or finance would be deterred from dealing with the debtor. For example, a financier intending to provide credit to the debtor to enable the acquisition of equipment would be very concerned about its priority. As a result of the attachment rules in s 40 (s 19 of the Australian PPSA) and the after-acquired property clauses of existing creditors of the debtor, any equipment financed would immediately be subject to the superior priority given to creditors with earlier perfected security interests under s 66 (s 55 of the Australian PPSA). Unless it could extract subordination agreements from all such creditors, which is hardly a practical solution, the financier could be expected not to proceed, or to do so only at the cost of a very high interest rate to reflect the risk. Taking title to the equipment as a form of security would not provide a solution either, as the transaction would be characterised as a security interest and the same PPSA priority rules would apply. Similar problems arise for suppliers of inventory on credit who use the goods supplied as collateral for their price, whether by retaining title or by allowing title to pass and then taking a security interest.<sup>43</sup>

A secondary concern is that giving priority to this property to a creditor which has neither facilitated its acquisition nor relied on its existence, just because it has an after-acquired property clause, would unjustly enrich that creditor at the expense of the party which has actually financed the acquisition of the property.<sup>44</sup>

The solution has been to provide for a special level of priority for providers of purchase money,<sup>45</sup> so that such creditors can have a security interest which is superior to the interest of any creditor relying on s 66. This super-priority is available without any need for the creditor to make special provision in its security agreement: all it needs to do is

42 Grant Gilmore “The Purchase Money Priority” (1963) 76 Harv L Rev 1333 at 1334. He points out an important justification (at 1336): allowing a secured party to claim \$50,000 of assets pursuant to a security is because at some time it contributed \$50,000 to the insolvent debtor.

43 Those who use accounts receivable as collateral face a similar problem, but the solution for them is not to be found in the purchase money security interest [PMSI].

44 Russell A Hakes “According Purchase Money Status Proper Priority” (1993) 72 Or L Rev 323 at 341.

45 Although some commentators track this as far back as *Nash v Preston* (1630) Cro Car 190, 79 ER 767 (KB), a more modern source is the United States Supreme Court decision in *United States v New Orleans Railroad* 79 US (12 Wall) 362 (1870) at 364. Bradley J said that allowing an after-acquired property clause to override the security of a purchase money creditor would be an “injustice”, which he resolved by holding that when the locomotives came into the hands of the debtor, they were already subject to a purchase money security: the earlier security could “only attach itself to such property in the condition in which it comes into the [debtor’s] hands”.