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legal update

A QUESTIONABLE PRACTICE

PPS vesting provisions on appointment do not extinguish a financier's perfected interest in leased equipment on the PPSR.

There is a practice amongst some liquidators and voluntary administrators to treat the vesting provisions [1] of the Personal Property Securities Act 2009 (Cth) (PPSA) as if they vest outright title.

A demand letter from a voluntary administrator (VA) to an equipment owner recently crossed my desk. It asserted that:

- the owner had neglected to perfect its security interest in some heavy equipment under the hiring agreement by registration of a financing statement on the PPSR
- the vesting provisions vested 'ownership' in the company in administration
- the owner would have to make an offer to buy the equipment back.

If that letter represents current practice it doesn't reflect the law.

THE ARGUMENT ADVANCED BY THE VA IN SUPPORT OF VESTING

A business that hires equipment on a commercial basis often finances its equipment fleet. The financier will usually perfect its security interest on the PPSR as against the owner.

In this case there was a financier who had registered on the PPSR and perfected its security interest as against the owner. However, the owner had failed to register its security interest on the PPSR as against the company in administration, which was the hirer of the equipment. The owner's security interest in respect of the hired equipment had accordingly vested in the company on appointment of the VA pursuant to s 267(2) of the PPSA.

The real question was the extent of the owner's security interest that had vested in the company.

The VA claimed:

- the company had hired the equipment from the owner in the ordinary course of business
- section 46 of the PPSA applied so that the company was vested with the security interest free of the financier's secured interest.

SECTION 46 – THE TAKE FREE RULE DEALING WITH LEASING IN THE ORDINARY COURSE

Section 46 is one of the 'take free rules' in the Act defining a situation in which a party to a transaction can take free of a perfected security interest.

Section 46(1) states that:[2]

> *A buyer or lessee of personal property takes the personal property free of* ***a security interest given by the seller or lessor****, or that arises under s 32 (proceeds – attachment), if the personal property was sold or leased in the ordinary course of the seller's or lessor's business of selling or leasing personal property of that kind.* (emphasis added)

The VA's position turned upon what was meant by the phrase 'a security interest given by the seller or lessor'.

Section 46 of the PPSA makes a distinction between 'a buyer' on one hand and 'a lessee' on the other:

- a buyer in the ordinary course of business takes a transfer of title to the personal property that is the subject of the transaction. There are no reserved rights to recover the property at the end of the transaction, or on default, as might exist where there is a lease. Section 46 permits the buyer to take outright title free of a security interest given by the seller to its financier.

1 Section 267 of the PPSA. **2** The take free rules in ss 44 and 45 have a quite different purpose and language to 46, so the same argument advanced in this case in relation to s 46 cannot be made in relation to those sections. That is because ss 44 and 45 deal with situations where the secured creditor has omitted or made an error in describing the relevant serial number (where required by the regulations) or has made an error in the number, preventing a search of the register from disclosing the registration.

- a lessee of property in the ordinary course of business does not take a transfer of title. The nature of the interest acquired is a right to possession valid for the term of the lease and subject to the terms of the lease. The lessor still retains a reversionary interest.

So in this case, although the owner's security interest (as lessor) had vested in the VA, the financiers' security interest was not affected. In turn, although the VA was free to deal with the leasehold interest in the equipment, the VA was not able to dispose of the equipment as if it owned it outright. For example, the VA could assign the leasehold interest to anyone who would buy it, but it could not sell the equipment unencumbered.

In practice, this analysis greatly limited the VA's ability to deal with the equipment because it was still subject to the financier's security. The result enabled us to convince the VA to settle with the owner for a much lesser sum than otherwise would have been the case.

CANADIAN SUPPORT FOR THE ARGUMENT

There is no case law on this issue in Australia, however Canadian authority supports the position: see Perimeter Transportation Ltd (re) *2010 BCAA 509; 2009 BCSC 1458* (Perimeter).

In Perimeter, the equivalent argument to the VA's was rejected conclusively both at first instance and on appeal.

The facts in Perimeter are set out in the judgment at first instance (*2009 BCSC 1458*). The heavy equipment at issue were buses on lease, where the owner (Century) had failed to register, and a financier (GE) who had financed the buses had registered. The buses were on lease to Perimeter, a bus operator at Whistler ski resort.

> The VA's position turned upon what was meant by the phrase 'a security interest given by the seller or lessor'.

In that case the Trustee of Perimeter (equivalent of a liquidator) relied on s 30(2) of the equivalent of the PPSA (Personal Property Security Act, RSBC 1996, c 359) which provides as follows:

> *A buyer or lessee of goods sold or leased in the ordinary course of business of the seller or lessor takes free of any perfected or unperfected security interest in the goods given by the seller or lessor or arising under s 28 or 29, whether or not the buyer or lessee knows of it, unless the buyer or lessee also knows that the sale or lease constitutes a breach of the security agreement under which the security interest was created.*

The Trustee argued that because Perimeter took the equipment free of GE's interest under s 30(2), then the Trustee took the buses free of GE's interest on Perimeter's bankruptcy.[3]

The decision considered the only two cases on s 30(2) or comparable legislation, *Car-Ant Investments Ltd. v Peat Marwick Thorne Inc.* (1990), 1990 CanLii 7521 (SK) QB, 84 Sask. R. 249 (Q.B.), and *North Sky Trading Inc. (Re)* (1994), 1994 CanLii 8986 (AB QB), 158 A.R. 117, (*sub nom. Davis Morris Fine Cars Ltd. v North Sky Trading Inc.*) 21 Alta. L.R. (3d) 107 (Q.B.).

These cases had conflicting outcomes.

The decision in *North Sky* was that the lessee takes the collateral free of any security interest and if the lessee makes an assignment in bankruptcy, the secured creditor's interest is subordinated to that of the trustee in bankruptcy. That is, the decision in *North Sky* supported the position of the VA.

However, the first instance decision of *Perimeter* rejected the reasoning in *North Sky* and held that the reasoning in *Car-Ant* (though brief and in obiter) was to be preferred:

> *In Car-Ant, Halvorson J., in discussing the Saskatchewan equivalent of s 30(2), was of the opinion that a validly-registered security interest in collateral which is the subject of a lease to a third party is unaffected by the failure of the lessor of the collateral to perfect its interest. This applies even if the secured interest was registered after the parties entered into the lease.*

The court went further and said:

> *From a policy perspective, the perfected security interests of creditors like GMAC and GE should not be subordinate to a trustee in bankruptcy merely because at the time the secured creditor entered into the security agreement, the debtor's interest in the collateral was unperfected. Section 20(b)(i) addresses the effectiveness of collateral which is unperfected at the date of bankruptcy, not at the date of the grant of an interest in the collateral.*[4]

The Trustee appealed this decision, and on appeal, the Court of Appeal for British Columbia found that the judge at first instance reached the correct result and dismissed the Trustee's appeal. It did so for different reasons.

3 At 68. **4** At 76.

The Court of Appeal held:

> *In my view, nothing in s 30(2) contemplates or requires that the Trustee acquires title to the buses free of the interest of GE in Century's perfected reversionary interest ...*
>
> *Here, we have a contest between the trustee of a lessee, and the holder of a perfected security interest granted by the lessor. That holder did what it was required to do by the PPSA to protect its interest. It is not a necessary result of the operation of s 30(2) in my opinion, that the Trustee acquires ownership of the goods themselves free of the interest granted by Century to GE. Both the policy underlying s 30(2) and the wording of the section itself require only that the Trustee remain entitled to the bankrupt's interest* ***under the lease****, free of all interests described in the section. This ensures that as long as the lease is extant, the lessee's rights will not be affected by the security interest granted by the lessor. The public interest in ensuring that the lessee gets what it bargained for is fulfilled and the Trustee may continue to enjoy the benefit of the lease as long as it is extant. In this regard, I agree with GE's submission at paragraph 53 of its factum:*
>
> *As summarised in Cuming above, a buyer of goods takes free and clear of prior security interests pursuant to s 30(2). This is because a buyer contracts for ownership of the goods being sold, and s 30(2) ensures that the buyer gets what he or she bargained for. A lessee, however, contracts for temporary use and possession of the goods under the lease. The lessee's interest is given protection under s 30(2) to the extent of what he or she contracted for.* ***A security interest given by the lessor cannot be asserted against the lessee to the extent of denying the possessory rights of the lessee. However, s 30(2) does not negate the security interest in the lessor's reversionary interest in the same way that it negates a security interest given by a seller (who has no reversionary interest)****. The role of this section is to ensure that the lessee's limited possessory rights are not affected by the security interest in the subject-matter of the lease.* (emphasis added) [5]

TAKEOUTS

The reasoning in *Perimeter* is sound, it is consistent with the legislation in Australia and there is no apparent reason why Australian courts should not follow it.

It is a powerful argument to deploy against the practice of insolvent administrators (either administrators, or liquidators or trustees in bankruptcy) who seek to rely on the vesting provisions.

In running the argument, the owner who fails to perfect will be in a much better bargaining position if they can secure the agreement of the financier to do so. In our case, we had two different financiers who both agreed, fortunately, to allow the owner to act as agents to recover the equipment, which allowed a single legal team to make the running. There is no real prejudice to the financier since ultimately the owner will be liable to make good the whole loss of the equipment if there is any loss of title.

There is a possible limitation to the argument advanced in this article, because of the uncertain scope of the provision governing survival of security interests on transfer of collateral, s 34 of the PPSA. It is beyond the scope of this article to deal with it in detail.

However, where there is a transfer of collateral from an owner, to a hirer (the company), it is arguable that s 34(2) has the effect of unperfecting the registration of the financier within five business days of the financier having actual or constructive knowledge of the leasing of the equipment to the hirer, requiring the financier to perfect against the hirer. There is no authority yet on this provision but various commentators have raised its possible effect.[6]

That said, secured creditors in the position of the financier should still seek to ensure that their downstream borrowers perfect their own security interests, despite the result in this case.

From a secured creditor's perspective, registration by the owner is still relevant and strongly recommended since:

- the credit risk of the owner will be adversely affected by the delay and transactional costs of recovering equipment if the owner has to bargain on behalf of the financiers to get it back
- likewise, registration will minimise the cost of recovery of the equipment in this country, where *Perimeter* has not yet been applied.

5 At 33. **6** See for example p. 9 of the paper by Bruce Whittaker of Ashurst, *Dealings In Collateral Under The Personal Property Securities Act 2009* (Cth) - In Search Of A 'Harmonious Whole', 8 February 2013 **https://law.adelaide.edu.au/documents/other/ppsa-dealings-in-collateral.pdf**