FORM AND FUNCTION IN CHATTELS FINANCING

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I. INTRODUCTION

We intend in this paper to investigate the various rights and often competing claims to goods which arise in the flow of business from the time of their manufacture to the time they are disposed of to the consumer. In this movement of goods from the manufacturing stage to consumer enjoyment, there are a number of points at which competing interests in goods are asserted. Thus the retailer selling on credit wishes to retain an interest in the goods as security for the unpaid purchase price, while the buyer may wish to treat the goods as if they were his own and dispose of or mortgage them. Alternatively, the distributor or manufacturer may wish to retain an interest in goods he sells on credit to a retailer and that interest will compete with the interests not only of the retailer but perhaps of the lender who has advanced money to the retailer on the security of those goods and of the consumer who ultimately purchases the goods. We may at any one point have competing claims asserted by the vendor of the goods, the lender to the vendor, the purchaser, the lender to the purchaser, the purchaser's general and secured creditors, the servicemen to whom the goods may have been entrusted for repair or the Official Assignee in Bankruptcy of either of the vendor or the purchaser.

In resolving these conflicts, the law is presently relying on rules of great antiquity, to be found in decisions of the Courts made for the main part more than a century past and in statutes of almost like vintage. Thus, our Sale of Goods Act, while passed in 1908, is almost identical to the Act passed in England in 1893 which in turn was a codification of court decisions given largely in the preceding century. Our Chattels Transfer Act passed in 1924 and modified from time to time since, has its genesis in New Zealand Statutes passed in the 1860's which in turn are based on earlier English acts. As one might expect, one result of this historical evolution is that the rules used to resolve the various conflicts are to be found in a plethora of statutes, regulations and decisions.

We do not mean to imply that old law is bad law. Venerable rules often embody the collective rather than the conventional wisdom of our forefathers, but when circumstance changes, when the mobility of goods replaces static trading, when from a cash system we develop a credit economy, conditions dictating earlier rules no longer justify their retention.

These rules generally provide for a given set of results from using a given form of transaction. Originally this manner of drafting may have been successful in regulating one and only one type of transaction. But thanks to changing conditions and imaginative counsel, this is no longer the case. The result is that a given transaction can be expressed in many different ways in spite of the facts that the equities of the situation remain the same. The rights and duties of the parties will vary with the mode chosen.

We seek to demonstrate this thesis and a pressing need for change by examining from a functional viewpoint the conflicting interests in goods and the method and result of their resolution under existing law. That is to say, we will examine the competing interests at different points along the chain of distribution from source to consumer. We start by asking what competing rights are likely to arise when the retailer disposes of goods on credit to the consumer. We then turn to the competing rights likely to arise on disposal of goods on credit from a manufacturer to a distributor or from a distributor to a retailer. Finally, we ask what additional interests in the goods are likely to arise where an outside lender has advanced money on their security, whether to the consumer, dealer, or manufacturer. Such an examination reveals we think a profound lapse, both between the desirable result and the actual result and between the rules formulated in a bygone age and those relevant to modern circumstance.

We think too that there will be revealed not only a gap between the desirable and actual results, but a tortuous and tricky path weaving an elaborate thread between innumerable statutes of disparate origin and common law principles of equally dissimilar genesis. In a word, the process of resolving the problems created by these competing interests calls for a mental agility that no one can be reasonably expected to possess.

II FINANCE PROVIDED BY THE DEALER

Take first the situation where the dealer undertakes to provide finance to his customer. The days are certainly gone where dealers could afford to insist on payment in cash. Today fully 40% of sales in New Zealand are financed by some form of consumer credit.[1] In such a situation, the dealer is in effect lending the customer money to purchase the dealer's goods. In fact, no money changes hands. Instead the dealer releases the goods to the customer in exchange for the customer's obligation to pay for the goods over a period of time. The security for the obligation is the dealer's right to repossess the goods.

The legal arrangements between the dealer and the customer can be expressed in many ways. The dealer could sell the goods to the customer with the customer immediately conveying an instrument by way of security, which we shall call a "chattel mortgage", over the goods back to the dealer. The customer will thus have "mortgaged back" the goods to the dealer. Or the dealer could sell the goods on what is popularly known as a hire purchase plan. In fact, this term covers two legal arrangements. In one, which we shall call the true hire purchase agreement, the customer rents the goods for a period of time with an option to purchase the goods at the end of this period.[2] In the second, which we shall call a conditional sale agreement, the customer agrees at the outset to buy the goods, paying the purchase price over a period of time.[3] Finally, the dealer could simply "lease" the goods to the customer.

These legal arrangements were originally designed to serve quite different ends. The "chattel mortgage" or instrument by way of security was meant for situations where an individual wanted to borrow money by giving goods already owned as security. Leasing arrangements were used where the customer did not want to permanently acquire the use of the goods. The addition of an option to purchase simply meant that he could change his mind without re-negotiating with the dealer. Yet each was molded to fit the needs of dealer and customer wanting to finance a sale. The chattel mortgage was combined with a sale to become one transaction. The true hire purchase agreement was written so that by the time the leasing period was up, the customer had in reality paid the purchase price, leaving the option to purchase as a rather hollow privilege. The straight leasing arrangement can be spread out over the useful life of the goods. If of shorter duration the lessee assumes all risks through the obligation to pay the excess over the 'residual value'.[4]

Thus each type of arrangement, though classified differently legally, had substantially the same result: the customer received permanent possession of the goods and was obligated to pay its price over a period of time; the goods were the security for his indebtedness. Only the conditional sale appears to describe the arrangement between the parties accurately. Why then adopt these different modes of expressing the transaction? The answer lies in the fact that the rights of the parties vary with the mode adopted.

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1. Department of Industries and Commerce, Submission to Tariff and Development Board, Public Inquiry, Hire Purchase and Credit Trading in New Zealand, 5.
2. These are often called a Helby v. Matthews, [1895] A.C. 471; [1895-9] All E.R. Rep. 821, agreement.
3. These are often called a Lee v. Butler, [1893] 2 Q.B. 318; [1891-4] All E.R. Rep. 1200, agreement.
4. This pattern has emerged strongly in the last year in New Zealand in the motorcar trade, the chief advantage being the avoidance of the Hire Purchase and Credit Sales Stabilisation Regulations 1967. See infra, p.30-31.

Consider, for example, the varying results when the customer wrongfully resells the goods to a third party. If a chattel mortgage has been chosen, and if the dealer neglects to register the agreement in the Supreme Court, the customer is empowered to destroy the dealer's rights to the goods by any sale to a bona fide purchaser.[5] The dealer may still, of course, enforce his debt; but he has lost his security and customers making such fraudulent sales are rarely men of means. If, however, a true hire purchase or conditional sale agreement is chosen, and if the goods involved are included in the Seventh Schedule of the Chattels Transfer Act 1924, the customer may not pass good title to anyone, even though the dealer has not registered the agreement.[6] If the goods are not included in the Seventh Schedule, the dealer must register to protect himself against wrongful disposition if he chooses a conditional sale,[7] but may not need to register if he chooses a lease or a true hire purchase agreement.[8]

Obviously little words mean a lot. Yet the pitfalls created for the dealer by these varying results might be bearable if these results were confidently and easily predicted. The intricate process which must be followed to reach the tenuous conclusion of the last sentence in the preceding paragraph is a good if extreme example of the nightmares facing the dealer's legal advisor. The Chattels Transfer Act 1924 was enacted in order to instill the principle of registration into the chattels security field. By and large, its drafters envisioned individuals wanting to use goods already owned by them as security for loans. So s.19 merely voids the agreement as against bona fide purchasers where no registration has taken place.[9] In other words, it destroys the rights of the customer rather than those of the dealer, since the dealer has title and the customer has rights in the goods only by virtue of the agreement. So far it looks as if the dealer will be protected without registration if he uses either a conditional sale or true hire purchase agreement.

The next step in the journey is to turn to the Sale of Goods Act 1908. This Act was not even remotely concerned with the chattels security field. Its goal was to elucidate the rights and duties of buyers and sellers of goods. Section 27 deals with the question of wrongful dispositions by sellers who have agreed to sell goods or buyers who have agreed to buy goods when either has possession. It validates sales under these circumstances to bona fide purchasers for value and without notice. What luck! Since the Chattels Transfer Act deems the world notified of registered instrument,[10] the dealer can now protect his rights under a conditional sale agreement by registration. But is a true hire purchase agreement a sale? Probably not, since the customer has only an option to purchase. Section 27 can be no help, since it speaks only in terms of buyers and sellers. And what more can you expect of a section in the Sale of Goods Act?

So we must return to the Chattels Transfer Act. Will s.19 be given its literal reading? At least one Magistrate thought so,[11] although no higher court has ruled on the question. It may well be that the words of the section would be given their intended rather

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5. Chattels Transfer Act 1924, s.19.
6. Chattels Transfer Act 1924, s.57. The agreement is then known as a "customary hire purchase agreement."
7. Sale of Goods Act 1908, s.27(2).
8. See infra, p. 29-30.
9. "... no unregistered instrument comprising any chattels whatsoever shall, without express notice, be valid and effectual as against any bona fide purchaser ... for valuable consideration."
10. Chattels Transfer Act 1924, s.4.
11. Carmine v. Howell (1924), 19 M.C.R. 103.

than their literal meaning.[12] But for the time being, no solicitor can give a confident opinion on the matter.

It is with relief then that we can report that by virtue of s.22 the rights of the dealer as against subsequent secured creditors are completely dependent upon registration, except for true hire purchase or conditional sale agreements involving goods included in the Seventh Schedule. The drafter's assumptions which caused the problems with s.19 carry over to s.18 as well. As a result, the dealer need not register a true hire purchase agreement, conditional sale agreement or a lease to be protected against the competing interests of the Assignee in Bankruptcy, assignee for the benefit of creditors, or execution creditors, even if the goods are not included in the Seventh Schedule.[13] Just the reverse is true for the chattel mortgage. And unfortunately, no outside act can be relied upon to save the day here.[14] The reputed ownership clause of the Bankruptcy Act 1908[14] served in the past to provide some hope to the Official Assignee; but the recent revision of that act eliminated that clause,[15] leaving naked the Chattel Transfer Act's failure to achieve its goal of preventing "secret liens" through registration.

The same discrepancies appear in regard to lien creditors. While the dealer cannot avoid innkeepers' or carriers' liens under any circumstances, the rights of a landlord levying distress vary with the plan used:[16] once again, the assumption that the customer has title in the goods results in the requirement of registration being applicable only to the chattel mortgage. Happily that assumption had disappeared by the time of the Hire Purchase Agreements Act 1939 and by that act the workman's lien is good whatever the agreement unless he has <u>actual</u> notice of the agreement.[17] But the Act inexplicably ignores the landlord's dilemma.

At this point it may be asked why a dealer would ever choose a lease. It seems to offer no advantages from the standpoint of competing interests. In part, the answer lies in the Hire Purchase and Credit Sales Stabilisation Regulations 1957. Enacted to help stabilise the economy through restricting credit,[18] these regulations require high minimum deposits and short periods in which to pay off the balance for all true hire purchase agreements, conditional sale agreements, and chattel mortgages. But they do not apply to leases, even though the modern chattels lease is in practice a financing

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12. Cf contra the opinion of the leading New Zealand writer on the subject. See Dugdale, <u>New Zealand Hire Purchase Law</u> 2nd Ed., 56 - 58.
13. "Every instrument, unless registered ... shall ... be deemed fraudulent and void as against - (a) The Assignee in Bankruptcy of the estate of the person whose chattels ... are comprised in any such instrument: (b) the assignee or trustee acting under any assignment for the benefit of creditors of such person: (c) Any Sheriff, bailiff, and other person seizing the chattels ... comprised in any such instrument, in execution of the process of any Court of the person by whom or concerning whose chattels such instrument was made, and against every person on whose behalf such proceed was issued...." This section does not apply to hire purchase agreement, conditional sale agreements, or leases for two reasons: (i) only the instrument is voided, leaving the creditor with his title; (ii) it is not the debtor "whose chattels are comprised in" the instrument. See <u>Booth, Macdonald and Co. Ltd.</u> v. <u>Official Assignee of Hallmond</u> (1913), 33 N.Z.L.R. 110; 166 L.R. 123.
14. Bankruptcy Act 1908, s.61(c).
15. Insolvency Act 1967, See footnote 53.
16. See Dugdale, <u>op. cit.</u>, 60, 63-4.
17.. Hire Purchase Agreements Act 1939, s.10. Unfortunately, this provision does not apply to hire purchase agreements at the <u>wholesale</u> level.
18. They were issued under the Economic Stabilisation Act 1948.

agreement.[19] Therefore the dealer may avoid these severe limitations through the lease. He is also enabled in this way to exchange the specific provisions regarding warranties in the Sale of Goods Act 1908[20] for the uncertain and certainly no more strict requirements of the common law.[21]

The dealer is thus compelled, or perhaps allowed is the better word, to choose between maximising his position relative to third parties or relative to his customer. Either way he is avoiding obligations which Parliament in one act or another sought to place upon him. The inclination of these laws to speak in terms of form rather than function compels the dealer to name his poison, meanwhile enabling him to put not only the customer but also the customer's other creditors at great disadvantage.

III FINANCE PROVIDED BY THE DISTRIBUTOR OR MANUFACTURER

Now we go back one step further up the chain. Instead of concerning ourselves with the dealers'problems in retaining an interest in the goods he sells to the public we take a look at the distributor or the manufacturer who sells one stage further back in the chain, i.e. the manufacturer selling to the distributor, the distributor selling to the retailer. The morality of the dealer might bear favourable comparison to the morality of the consumer but this does not mean the dealer is a better credit risk. All of you in the business community will be familiar with the dilemma. The sales people want their figures up; the credit manager wants the cash. If the customer is a marginal credit risk you do not make the sale or if you do you wish you had not. If you had a cheap and effective security device maybe you could make your sale and still have the cash. This is a problem for all sellers above the retail level.

Of course there are well known ways of bridging the security gap and sometimes getting the cash at the same time. As is common in the food industry you can guarantee the customer's bank overdraft and take a debenture or rest on subrogation rights to the bank's debenture, or you can sell on hire purchase and discount the agreement, supply the goods on a consignment basis, or sell to a finance company who leases the goods on some kind of floor plan or stocking agreement whereby title to the goods is retained. You might even sell and take a chattel mortgage back to secure the unpaid purchase price or take a debenture over the customers business to secure all unpaid debts.

Thus there is a wide range of choice as to the security device the wholesale seller (i.e. distributor or manufacturer) might employ to secure the unpaid purchase price. Our main point is that functionally the exercise is the same in each case. Yet the results of the choice of the device to be used are very different and many of the differences are without justification. If the wholesale seller secures the unpaid price by taking or retaining an interest in the goods sold there will be a number of possible competing interests which may arise in relation to those goods. We will consider those competing rights against the background of a wholesaler supplying goods on credit to a dealer and securing the purchase price by one of the devices already mentioned, namely a debenture, chattel mortgage, consignment sale, a true hire purchase agreement, conditional sale agreement, or floor plan agreement.

One would think that the buyer in the ordinary course of business from the dealer ought to take free of any interest in the goods the wholesaler may claim. If the wholesaler's security interest arises under a floating charge in a debenture, a true consignment plan, an unregistered true hire purchase or conditional sale agreement,

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19. With the exception of television sets. See Amendment No.10, S.R. 1965/144.
20. ss. 14-17.
21. See Dugdale, op.cit., 24 - 6.

or unregistered chattel mortgage, the buyer will take the goods free of the wholesaler's interest.[22] On the other hand, if the wholesaler's interest arises under a fixed charge in a debenture, a registered chattel mortgage, a registered true hire purchase or conditional sale agreement the buyer will secure the goods subject to the wholesaler's interest in those goods.[23] If the dealer is an individual and not a company, the buyer in the ordinary course will in most cases take free of the wholesaler's interest even though a chattel mortgage is registered.[24] As a further gloss, if the buyer in the ordinary course is really a lessee of the goods, he may be subject to the wholesaler's interest even in the case of a consignment plan, unregistered true hire purchase or conditional sale agreement or unregistered chattel mortgage between the wholesaler and the retailer.[25] Finally even the buyer outside the ordinary course will succeed as against the wholesaler where the wholesaler has a floating charge debenture. The position is yet further complicated where the security arrangement between the wholesaler and the dealer covers goods acquired after the date on which the security instrument between the wholesaler and the dealer is signed. For example, a chattel mortgage under these circumstances will secure for the wholesaler an interest which may take priority to that of the buyer in the ordinary course where the dealer is a company. Conversely, if the dealer is an individual, the buyer in the ordinary course would take priority.[26] We start with the simple question, does the buyer in the ordinary course take priority over the wholesaler where the wholesaler claims an interest in the goods to secure purchase money unpaid by the dealer? As you can see, the answer is subject to so many refinements and exceptions as to make it impossible to give a straight forward answer to the question posed. More significantly, the qualifications and exceptions arise in a large measure from the type of security device the wholesaler adopts.

Let us now briefly consider the wholesaler's rights vis-à-vis the liquidator, Official Assignee, execution creditors, prior lenders, lien claimants and landlords.

The liquidator gains priority if the wholesaler's rights rest on an unregistered chattel mortgage or debenture but not where they rest on an unregistered conditional sale or true hire purchase agreement.[27] The Official Assignee's position is now similar since the reputed ownership doctrine has been abolished.[28] Generally the wholesaler will take priority over the dealer's execution

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22. Consignments: Sale of Goods Act 1908, s.23; Merchantile Law Act 1908, s.3; Hire Purchase Agreement: Merchantile Law Act 1908, s. 3; Sale of Goods Act 1908 s.27(2); Unregistered chattel mortgage: Chattels Transfer Act 1924, s.19.
23. Fixed charge in debenture: Companies Act 1955, s.102(12); Chattels Transfer Act 1924, s.4(2); cf. Sher & Allen, "Financing Dealers' Stock-in-Trade" (1965), 1 N.Z.U.L.R. 371 at 419.
24. Chattels Transfer Act 1924, s.19. The holder of the instrument is usually unable to comply with s.23 of that Act which requires a schedule of the chattels affected. This requirement does not apply to instruments granted by Companies. Chattels Transfer Act 1924, ss.2, 59.
25. This would depend on whether a lease is regarded as a disposition under Merchantile Law Act, 1908, s.3, Sale of Goods Act 1908, s.27(2).
26. Chattels Transfer Act 1924, ss. 2,24, 59.
27. Where the security is a 'charge' Companies Act 1955, s.103 (companies) or Chattels Transfer Act 1924, s.18 (individuals) applies but where title is retained by the wholesaler the liquidator or official assignee has no greater right than the 'hirer'.
28. See footnote 53.

creditors where the security comprises a fixed charge in a debenture, a registered chattel mortgage, a consignment agreement, a floor plan or a true hire purchase or conditional sale agreement registered or unregistered. On the other hand, the wholesaler will fail against the execution creditors if the wholesaler's security is a floating charge in a debenture,[29] an unregistered chattel mortgage[30] or a registered chattel mortgage where the dealer is an individual and not a company.[31]

Another competing interest arises where a prior lender has advanced moneys to a dealer on the security of stock to be thereafter acquired by the dealer. Where the lender's security (earlier in point of time) is comprised in a chattel mortgage or debenture given by a dealer company, the wholesaler probably fails,[32] but on the other hand he succeeds where his security is comprised in a hire purchase agreement or a consignment or floor plan.[33]

The rights of a lien claimant also differ depending on the nature of the wholesaler's security interest. The competing rights in this situation arise where the dealer hands the goods to a third party for repairs and the third party retains possession of the goods claiming a lien thereon until he is paid. The lien claimant will probably take priority to the wholesaler if the wholesaler's interest is comprised in a floating charge under the debenture but the wholesaler will take priority if he holds a registered chattel mortgage containing the appropriate provisions to protect him against liens.[34] Again, if the wholesaler's interest is comprised in a true hire purchase or conditional sale agreement, he may take priority depending on the terms of the agreement.[35] The landlord levying distress on the dealer's goods for unpaid rent will take priority if the wholesaler's interest arises under a floating charge[36] in a debenture but not where the wholesaler's interest stems from a true hire purchase or conditional sale agreement.[37]

It seems clear the competing claims of the wholesaler and the buyer in the ordinary course, the liquidator, execution creditor, lien claimant, prior and subsequent lender and landlord should be resolved in the same way in each case regardless of the nature of the wholesaler's security interest. Yet once again it is the formal differences, unrelated to function, which are all important.

IV FINANCE PROVIDED BY THE FINANCER

We have considered broadly security interests at the retail level and security interests created in favour of merchants to secure unpaid purchase price, and in that regard we have dwelt upon the different priorities which arise depending on the form of security used. We now pass to consider securities taken not by a merchant but by a financer or lender where the collateral comprises stock-in-trade.

In this area there are problems which relate peculiarly to the

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29. Provided that execution is completed before the charge attaches.
30. Chattels Transfer Act 1924, s.18.
31. See note 3, <u>supra</u>.
32. The prior instrument will probably contain instructions against creating further charges of which the wholesaler will be deemed to have notice. Chattels Transfer Act 1924, s.4; Companies Act 1955, s.102(12).
33. Because the goods not being the dealer's property do not come within the lender's charge.
34. The lien claimant will be deemed to have notice of such provisions; Chattels Transfer Act 1924, s.4.
35. Hire Purchase Act 1939, s.10 does not apply to hire purchase agreements at the wholesale level - see definition of 'hire purchase agreement' in that Act. As to the effect of provisions in the agreement on liens, <u>cf.</u> <u>Moyes</u> v. <u>Magnus Motors</u> [1927] N.Z.L.R. and <u>Tappenden</u> v. <u>Artus</u>, [1964] 2 Q.B. 185.
36. <u>Re Roundwood Colliery</u>, [1897] 1 Ch. 373.
37. Distress and Replevin Act 1908, s.3(1).

the financer's position. Typically, a lender may finance a retailer by financing his hire purchase agreements so as to carry the credit after sale by the dealer. Sometimes this is done by factoring the dealer's book debts, but more usual in this country is the procedure whereby the dealer discounts[38] his hire purchase agreements or sells the goods to the financer in the first instance who then sells to the consumer on hire purchase.

Even at this level differences of form assume an importance which transcends any functional difference. Thus in the discounting scheme the financer is answerable in respect of misrepresentations made by the dealer concerning the goods and if the consumer can establish a misrepresentation this will, subject to exception clauses, provide a good or partial defence to an action brought by the financer for unpaid instalments. Where, however, the hire purchase agreement is entered into by the financer direct with the consumer, there is some doubt as to whether the dealer is the financer's agent and misrepresentations made by the dealer may not be visited on the financer.[39] Again, a difference arises in the operation of the two systems where the hire purchase agreement is illegal by reason, say, of failure to comply with the Hire Purchase and Credit Stabilisation Regulations 1957. In the discounting scheme, the financer is not affected by that illegality in an action brought against the dealer[40] whereas he may have no remedy if the hire purchase paper is concluded on a direct sale by the financer.[41] Furthermore, in the discounting scheme, the financer is not liable to the consumer to refund the deposit in the event of breach of the aforementioned regulations, whereas he is so liable on the direct sale basis.[42] Again, the direct sale basis involves quite different considerations under the Door to Door Sales Act 1967 to those which arise under a discounting scheme.[43] In England and Australia, practically all hire purchase financing is done on a direct sale basis by the financer, but in New Zealand the reverse is true. We would have thought that results should be the same whichever scheme was used for the reason that the financer is not a dealer or vendor in the functional sense in either situation.

We now turn to the financer's interests in a rather different area, namely, where a merchant or manufacturer seeks credit in order to enable him to carry stocks as distinct from financing his credit sales. This is the area commonly known as stock-in-trade or inventory financing. Here we have three outstanding problems.

Firstly, stocks in the hands of manufacturers change character, progressing from raw materials to a finished product. In the course of this process the raw materials are changed in nature and countermingled with other materials or parts. This gives rise to the following questions:

(a) How do you describe and identify raw materials and materials in a changing state?
(b) Does your security interest extend to materials and parts added in the course of manufacture?
(c) How do you reconcile a security interest in, say, the raw materials and a separate security interest taken by

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38. This term, while commonly used, is a misnomer. For tax reasons (Stamp Duty) the dealers agreements are assigned to the financer by way of mortgage.
39. Financings Ltd. v. Stimson [1962] 3 All E.R. 386, 388 cf. Northgran Finance Ltd. v. Ashley, [1963] 1 Q.B. 477, Campbell Discount Co. Ltd. v. Gall, [1961] 1 Q.B. 431, A.D. Hughes 'Agency in Hire Purchase Transactions' (1964), 27 M.L.R. 395.
40. Portland Holdings Ltd. v. Cameo Motors Ltd. [1966] N.Z.L.R. 571.
41. A dealer's indemnity would presumably be an indemnity for the consequences of an illegal act and therefore unenforceable.
42. Hakwes Bay Credit Corp. v. O.A., [1964] N.Z.L.R. 154.
43. E.g. on the direct sales basis the finance company is the vendor and is primarily liable for returning deposits and trade-ins, (which it never in fact receives) if the purchaser exercises his right to cancel during the seven day "cooling off" period provided by this Act.

another lender in other raw materials or parts which are incorporated in the project during the manufacturing process?

The second problem is to include within the security goods which are purchased after the loan is made and which are used to replace sold goods originally comprised in the security. It is essential in this type of arrangement that the merchant be free to sell his stock-in-trade in the normal course of his business and it is also essential that purchasers should acquire that stock free of any security interest. Accordingly, from the lender's viewpoint there must be an assurance that the security will not be dissipated but will be replaced on sale with goods of a like order or the proceeds from the disposal of goods originally comprised in his security. This second problem then relates to security interest in the proceeds of disposal of stock and in replacement stock often called "after acquired property".

Thirdly, the lender is concerned to know whether his security will cover further advances made after the signing of the security agreement. The arrangements must be flexible enough to permit of a continual flow of moneys back and forth from the financer to the merchant. Moneys will be advanced to meet the cost of particular shipments and moneys will be repaid as goods are disposed of. Between the lender and the merchant there may be a current account or there may not.

The security devices presently available in this area comprise debentures, chattel mortgages, and a form of manufacturing agreement. Where the stock-in-trade does not change in character through a manufacturing process, some form of stocking, floor plan[44] or consignment arrangement can also be used. Each of these securities is deficient in one respect or another and each of them gives different results when there are competing claims made against the goods by third parties such as creditors, purchasers and the like.

The main difficulty with the debenture is that the financer has no protection in respect of disposals of the stock-in-trade which are made outside the ordinary course of business. In general, the purchaser will take priority, notwithstanding that he buys, say, the whole of the merchant's stock-in-trade at a considerable undervalue.[45] Furthermore, the rights of the lender against those with competing claims to the goods, depends on a rather artificial happening, namely, the crystallisation of the floating charge. This is effected by the appointment of a receiver and at that point the priorities are all radically altered even though crystallisation of the charge may not be known to third parties.[46] Furthermore, the lender, prior to crystallisation, loses his security interest to execution creditors and landlords distraining for rent. His charge

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44. We have used the term 'floor plan' as distinct from a consignment plan to connote those arrangements whereby the title to stock in trade is held by the financing party and a bailment is at some point created in favour of the party financed. Consignment plans, then, are confined to arrangements where there is no bailment and the relationship between the parties is simply that of principal and agent.

45. There is great difficulty in attacking such a transaction as a fraudulent preference or conveyance. New Zealand has no equivalent to the Bulk Transfer provisions of the U.C.C.(Art.6).

46. While Companies Act 1955 s.346 requires company documents, including invoices and orders, to note the appointment of a receiver cash buyers from dealers, to take but one example, have no means of knowing that the change has attached.

is also subject to certain priorities in favour of the merchant's employees, whereas no such priorities are available where one of the other security devices is selected. Finally, this type of security does not effectively secure later advances where the lender has notice of another charge.[47]

The chattel mortgage is a neglected device in this field. Where the merchant is a company, it affords opportunities to a lender which, for some reason, have not been taken advantage of. If the merchant was an individual, the registered chattel mortgage would provide only the most scant protection because the requirements of the Chattels Transfer Act dealing with description of the goods and after acquired property cannot be met. These restrictions do not apply to a chattel mortgage given by a company,[48] and for that reason the chattel mortgage would appear to be a device open to the inventory financer. We speculate that one reason for its neglect lies in the tortuous nature of the legislation which has disguised the description and after acquired property exemptions from the financer's scrutiny.[49] On the other hand it is possible that a chattel mortgage over stock-in-trade would be held a floating charge to be found in a debenture. To hold otherwise would be to go too far in protecting the lender inasmuch as notice of the contents is notice to the world[50] and buyers in the ordinary course may find that they take the goods subject to the financer's security interest. Notwithstanding that it might be held to be a floating charge, we feel that it still might be useful because borrowers may be reluctant to grant debentures, but have no such resolutions about a chattel mortgage.

The so-called manufacturing agreement is an ingenious adaption which endeavours to meet the problems posed by the changing nature of stock through a manufacturing process. In essence the financer buys the raw materials either direct from their source or from the merchant, whereupon the merchant acknowledges that title in the materials passes to the financer and agrees to manufacture from those materials the finished product. The manufacturer will also acknowledge that title to any parts or further materials incorporated during the manufacturing process passes upon incorporation to the financer. When the goods are manufactured the financer pays the merchant a sum to cover the additional goods incorporated in the finished product and the costs of manufacture. Title remains throughout with the financer. The difficulty is that the financer will endeavour to pass the risk of non sale to the merchant and require him to purchase back the goods after a fixed period. In documenting this aspect, the manufacturing agreement may be brought within the definition of an instrument in the Chattels Transfer Act. Furthermore, the master agreement usually provides for advice notes under which further deliveries of raw materials are brought within its terms. These advice notes may also come within the Act and as a result, the financer's security interest would be defeated by, for example, execution creditors. Looked at from another viewpoint, the arrangement, if effective, permits of the creation of secret liens and goes too far in the financer's favour.

Consignment plans, stocking and floor plan agreements are used where stock is, throughout the relevant period, in a finished or constant state. Usually, however, the documentation brings into play the provisions of the Chattels Transfer Act and for that reason, falls short of the ideal.

Superimposed on the difficulties outlined is the horrifying spectre of the Moneylenders Act. Ironically there is a risk that

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47. The Property Law Act 1952 s.80A may not apply. See on this point and generally on the status of a debenture as security device Sher and Allen, loc cit., 410, 421.
48. See note 24, supra.
49. National Provincial Bank of England v. United Electric Theatres Ltd., 1 Ch. 132 [1916].
50. Chattels Transfer Act 1924 s.4.

the Courts will depart from the formal approach and adopt a functional viewpoint,[51] thereby regarding the security devices cast in the form of bailments or sale and purchase agreements as moneylending arrangements. Where the Moneylenders Act applies, the position is quite hopeless; future advances are not possible and variations of existing arrangements are precluded. Unquestionably this Act has contributed materially to the proliferation of security devices. For those caught within the jaws of the Act there is a constant search for means of financing a transaction other than by means of a loan. Among its long catelogue of sins must be featured its mandate to search for differences of form rather than function. This above all is the most urgent need: the repeal of most of the Moneylenders Act in its application to commercial loans.

At this point you might well ask whether apart from the Moneylenders Act there is a pressing need for revising our security concepts in the stock-in-trade field. There is no doubt that the bulk of finance required for this purpose is obtained from banks on the security of a bank debenture and it must also be recognised that the debenture itself goes a considerable distance in meeting the requirements of an effective security device in the inventory financing field. Nevertheless, there is at present a sufficient volume of business undertaken mainly by larger finance companies upon floor plans, consignment plans, so-called manufacturing agreements and the like to establish that there is an existing demand for inventory financing beyond that which the banks are prepared to carry. We think this trend is likely to accelerate and that the demand for financing stock-in-trade is likely to grow. The rapidly developing manufacturer or merchant will inevitably go through periods when his financing is thin and it is to the advantage of the country as a whole that such a manufacturer should, in this stage in his development, have access to inventory financing. To the extent that more effective security advices will bolster the confidence of lenders, reform in this area is in our view worthy of attainment.

V CONCLUSION

It should be obvious by now that the kind of reform we are arguing for is one which will make the legal results of financing agreements depend on their function rather than their form. As we have tried to show, the duties and priorities of the person providing finance for the acquisition of chattels, be he dealer, distributor, manufacturer, or finance company, vary greatly with the name he gives his agreement. We are not saying that the rules should be the same for all these agreements. Certainly policy considerations differ depending on who is giving the finance and who is receiving the goods. But variations in the rules should reflect these differences, which are differences of function, rather than the arbitrary and artificial differences of characterization.

This is not to say that New Zealand law completely ignores the functional approach. The difference in the rights of the buyer in the ordinary course depending on whether the party holding the goods is dealer or consumer shows recognition of this principle. The distinction is based on function: anyone taking security in goods held by a dealer should know that he is in business to sell these goods. He should not then be preferred to the innocent purchaser. The same factors do not apply if the financed goods are in the hands of a consumer.

In fact, much of recent commercial legislation adheres to these ideas. The Hire Purchase and Credit Sales Stabilisation Regulations

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51. There is little consistency in the attitude of Courts; See General Motors Acceptance Corp. v. Traders Finance Ltd. [1932] N.Z.L.R. 1; Cash Order Purchases Ltd. v. Brady, [1952] N.Z.L.R. 898; Cf. Olds Discount Co. Ltd. v. John Playfair Ltd. [1938] 3 All E.R. 275; Metropolitan Discounts and Inv. Co. Ltd. v. Bowra Radio and Elec. Ltd. (1944), 18 A.L.J.R. 88.

1957 are drafted so as to apply only to sales at the retail level.[52] The new Insolvency Bill passed this year eliminates one of the arbitrary differences in the rules applicable to private traders and companies.[53]

What we long for, then, is the application of this idea to the earlier statutes which lay down the fundamental rules applying to secured transactions in goods. The most important of these, the Chattels Transfer Act 1924, was formulated at a time when nearly all financing of goods was at the retail level or on the farm. The rules enacted for these kinds of transactions bear little if any relevance to the sophisticated forms of finance currently being used all along the chaim of distribution. The Moneylenders Act 1908 shares this disadvantage. Some of the problems with the Chattels Transfer Act are obviated by rules contained in legislation designed for other purposes whose relevance is a happy coincidence. As a result, the path to the answer is a tortuous one, full of ambiguities, undecided questions, and arbitrary distinctions.

New Zealand is not the first country to seek a single, rationally designed statute to govern this area. The American Uniform Commercial Code was developed by intensive work over a twenty year period and is now in force in 49 of the fifty United States jurisdictions.[54] Article 9 of the Code purports to fulfill this need. Of course, many of the legal facts of life in the United States are different, such as the federal system and the absence of the floating charge. But the Canadian province of Ontario last year led the way by introducing a version of Article 9 modified to suit Commonwealth law.[55] We propose to glance briefly at the basic concepts of Article 9 to demonstrate the possibility of a functional statute.

First of all, Article 9 replaces the welter of historical and formalistic distinctions among the various kinds of security held by the lender with a single term, "security interest." It is defined as any "interest in personal property or fixtures which secures payment or performance of an obligation. The retention or reservation of title by a seller of goods notwithstanding shipment or delivery to the buyer ... is limited in effect to a reservation of a 'security interest.' ...unless a lease or consignment is intended as security, reservation of title thereunder is not a 'security interest.'"[56]

All of the rules in Article 9 are then worded in terms of security interests. Therefore, characterization of an agreement as hire purchase, conditional sale, chattel mortgage, consignment, floating charge, or lease is totally irrelevant if the agreement is a security interest as defined above. So it is impossible to vary the rules to which the creditor or debtor is subject by this kind of characterization.

This does not mean that all security interests are subject to the same rules. Article 9 also places all goods into one of four categories:[57]

1. "consumer goods" if used or bought for use for personal, family or household purposes;
2. "equipment" if used or brought for use primarily in business;
3. "farm products" if crops, livestock, or supplies or

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52. See s.2(3)(a).
53. The new Insolvency Act 1967 contains no equivalent to s.61(c) of the Bankruptcy Act 1908, which empowered the Official Assignee to seize goods "in the possession order and disposition of the bankrupt by the consent and permission of the true owner, under such circumstances that the bankrupt is the reputed owner thereof." There was no such provision in the Companies Act 1955, which governs the liquidation of companies.
54. On the history of the Code, see Malcolm, "The Uniform Commercial Code in the United States: (1963),12 Int. & Comp. L.Q. 226.
55. Ontario Personal Property Security Act 1967.
56. s. 1-207 (37).
57. s. 9-109.

unmanufactured products of livestock or crops in possession of a debtor-farmer;

4. "inventory" if held by a person for sale or lease or to be furnished under contracts of service or if raw materials, work in process or materials used in the business. This term roughly corresponds to what is called "stock-in-trade" in New Zealand.

Because these are overlapping definitions, it is provided that if goods are farm products, they are neither equipment or inventory; if they are inventory, they are not equipment; and if they are neither inventory, farm goods or consumer goods, they are equipment.

But the important point to note is that goods are classified by use rather than by type. Thus typewriters are inventory (stock-in-trade) when bought and held for a sale by a dealer, but become consumer goods when purchased for personal use. This allows special rules to be developed for different parts of the distribution chain. For instance, rules aimed at dealer-financer agreements apply to "security interests in inventory." In this simple and understandable way, differences relating to function are expressed in terms of function. This eliminates much of the confusion and inconsistency resulting from the use of form as a means of identifying the agreements to which certain rules apply.

We do not offer Article 9 as a panacea for all of New Zealand's problems. It was drafted in response to American laws and customs. Because of this, many of its finer points are irrelevant or unsuitable to New Zealand conditions. Moreover, New Zealand has concepts unknown in the United States such as the floating charge, which may be helpful in minimizing the change necessary to effect a functional system.

One final note of caution. That present New Zealand law in this area is unsatisfactory is not the result of legislative or judicial incompetency. It is explained by the phenominal changes which have taken place in the commercial world. There is no reason to assume that these changes will not continue to take place. As it does, re-examination of the laws will be continually necessary to see that they keep pace with commercial practices. Even now it is becoming apparent in the United States that Article 9, for all its revolutionary character, must be revised. This has led its chief draftsman to state "Codification, we may conclude, is much more successful in abolishing the past than in controlling the future... If we keep a firm grasp on the basic principle of statutory obselescence, we should have no more trouble in living with the Uniform Commercial Code than our predecessors had in living with the Sales Act and the N.I.L."[58]

None of us can expect a complete and final reform. What we do ask for is a beginning. We appeal to all of you who are involved in the practical side of the law for guidance and support. Efforts are now being made by the Legal Research Foundation to advance reform in this area. The advice and insights provided by the men of business has been and will continue to be invaluable. But we also need your support. Reform in this extraordinarily complex area cannot be achieved on a part time basis. Hours and hours of research, of interviewing, and of discussion are needed before this part of the law can be brought into line with the modern business world.

Short of a full time research officer, well versed in the application of the Code we do not see how this can be done. With the best will in the world part time committees, the Law Revision Commission, and officers of the relevant Government departments are likely to have neither the time nor the background required to produce the draft legislation needed and to distil the one hundred and one viewpoints which will be brought to bear. An advisory

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58. Gilmore, "On Statutory Obsolescence" (1967), 39 Colo.L.Rev. 461, 476-7.

committee composed of members of business world, representatives of finance houses, practising lawyers and members of this Foundation have already performed valuable services and this paper draws heavily on its deliberations. Such committees require the co-ordinating power and leadership most likely to be found in the person of one experienced in the introduction of the Code in the United States or the Personal Property Security Act 1967 in Ontario.

It would be our recommendation that such a person be brought to New Zealand under the auspices of this Foundation or some similar body with an interest in this field.

C.J. Fernyhough and E.H. Flitton