SECURITIES OVER FUTURE GOODS

PART TWO

(continued from p. 150)

In the first part of this article it was seen that the law has not developed a satisfactory device to enable the granting of securities over future goods. Sections 23 and 24 of the Chattels Transfer Act 1924 effectively preclude the use of the instrument by way of security for this purpose and the floating charge suffers from a number of weaknesses. Apart from the fact that it is available to incorporated companies only, its major limitation is that it does not attach specifically to the company's property until an event has occurred, usually the appointment of a receiver, which causes the charge to "crystallize" so that in the meantime the company may deplete the security and intervening encumbrancers or execution creditors take priority. A more satisfactory method of securing future goods is required to enable a dealer to finance his stock-in-trade.

It is proposed now to evaluate the policy considerations which should be taken into account in formulating any change in the law. This will be followed by a discussion of the American and Canadian solution to the problem of future goods and the recent proposals for reform in New Zealand.

III. POLICY CONSIDERATIONS

One of the objects of the first part of this article was to highlight the circumstances which led to the enactment of the various restrictions on the granting of securities over future goods in England and New Zealand. These circumstances hardly justified the making of the restrictions, let alone justify their continuance. It has been seen[1] that, in England, it was the fraudulent conduct on the part of unscrupulous moneylenders which led to the prohibition[2] on the inclusion of future goods in bills of sale, the object being to prevent debtors in their own interests from mortgaging away all their future assets for the purpose of present credit and also to protect general trade creditors. It was the fraudulent conduct of moneylenders in *enforcing* their securities which often resulted in debtors being left ruined and trade creditors unpaid. Although in theory moneylenders could recover only the amount of any outstanding advances, it was quite common for them to enforce their securities over after-acquired goods by selling them at sham auctions. In this way trade creditors were defrauded and debtors ruined, and it is submitted that the English legislature unnecessarily restricted legitimate business concerns by prohibiting *all* bills of sale over future goods rather than enacting measures to eradicate the root cause of the evils — the fraudulent practices of moneylenders.

1. Ante, pp. 132-133.
2. By the Bills of Sale Act (1878) Amendment Act 1882, ss. 4, 5 and 9.

The Chattels Securities Amendment Act 1883[3] was the first New Zealand statute to prohibit securities over future goods. Although its object was to protect general trade creditors, it has been seen[4] that the legislature was probably not concerned with curbing the use of after-acquired property clauses in bills of sale. In practice, the method adopted by lenders in New Zealand for securing a debtor's future goods had been the inclusion, in bills of sale of specific goods, of general powers to seize future goods. One of the evils of this practice was that a seizure was valid even if the bill of sale had not been registered. In view of these considerations, it is submitted that the 1883 Act went further than a reasonable view of its object would have warranted.

Subsequently, the Chattels Transfer Act 1924[5] has allowed instruments comprising future goods to remain valid as between grantor and grantee, the legislature having thus clearly expressed that its intention was to protect general creditors, rather than to prevent debtors, in their own interests, from mortgaging away their future assets.

Both in England and New Zealand, company charges were excluded from the Bills of Sale Acts, and, as a result, they have until the present day been able to include future goods. The somewhat artificial reasons originally given for this exclusion were that company debentures were well-known in the commercial world and the Companies Acts already required them to be registered (even if it was only at the *company's* office). No satisfactory reason has ever been given justifying the differential treatment accorded to company securities as opposed to those granted by unincorporated traders.

Can a change in the law now be justified, especially with regard to securities over a dealer's stock-in-trade? The businessman regards his stock-in-trade as a single unit. To him it is basically an unchanging whole with only changing parts. Should the law draw distinctions between present and future goods in this context?

It has been suggested that the policy consideration which dictated the restrictions in ss. 23 and 24 of the Chattels Transfer Act 1924 was the need to prevent a borrower committing himself too far into the future, and that this consideration did not seem valid in the field of financing dealers' stock-in-trade.[6] However, the basic premise of this argument is incorrect. As mentioned above, the policy behind ss. 23 and 24 was clearly not the protection of the borrower. If it was, Parliament would have rendered instruments comprising future goods void as between grantor and grantee. Accordingly, it is necessary to seek some other justification for a change in the law relating to securities over future goods.

3. Sections 5 and 6.
4. Ante, p. 142.
5. Sections 23 and 24.
6. Sher and Allan, "Financing Dealers' Stock-in-Trade" (1965) 2 N.Z.U.L.R. 371, 435.

There are three major interests or policy considerations to be balanced when evaluating the wisdom of any changes in the law. Stated at their most basic level, they are:

(1) "Permitting parties to realise on future prospects by present . . . encumbrances of their chances or expectations, for a present price paid, would make available a considerable additional range of intangible assets for present use in supporting productive activities for the more complete satisfaction of human wants."[7]

(2) On the other hand, "if such a framework can extend indefinitely into the future, the possibility would be open of a man's alienating for present advances not to [ensure] his entire personal freedom, but still the entire produce of his labour for an indefinite period in the only line in which he knows how to make a living — a somewhat refined sort of peonage."[8]

(3) The rights of unsecured creditors deserve some protection. If the law recognises securities over future goods, it may be that, in the event of a trader's insolvency, nothing will be left to satisfy their claims. Should a cushion of free assets be preserved for their protection?

Commercial Utility

Obviously the main argument for a change in the law relating to securities over future goods is that, although stock-in-trade can perhaps never be regarded as an ideal form of security, it is commonly all that a dealer can offer, and in the interests of business development it would seem desirable that he be allowed to obtain working finance against the security of that property. It would help in "supporting productive activities for the more complete satisfaction of human wants". Once the commercial utility of permitting a dealer to finance against the security of his stock-in-trade is accepted, then it is virtually a contradiction in terms to say that such security should not extend to *future* stock. Any security agreement over stock-in-trade must include a provision that it is to attach to future stock since the existing stock will necessarily be disposed of in the ordinary course of business.

The Lending Monopoly Danger

On the other hand, it may be argued that the recognition by the law of securities over future goods could eventually lead a debtor into "a somewhat refined sort of peonage". There is the possibility that one lender will get a stranglehold on the debtor for, being shielded from competition, he may be able subsequently, for example, to extract a higher rate of interest. Public policy, therefore, requires the protection of a necessitous borrower against himself by refusing to allow him to encumber all future goods in order to secure a present loan.

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7. Vold, *Sales* (1931) 101-102; see also (1951) 2nd ed. 235-236.
8. Llewelyn, *Cases and Materials on the Law of Sales* (1930) 577.

Public policy would undoubtedly require such a restriction in the case of a private individual attempting to mortgage say, all his present and future household furnishings, but would it require such a restriction in the case of a person *dealing* in those goods? The following points can be raised against the lending monopoly argument. First, it is said that the recognition of the after-acquired property clause would place the secured party in a strategic position over his debtor and stimulate monopoly financing; unscrupulous lenders might unreasonably tie up all of a dealer's assets and thereby monopolize his sources of credit. However, where this is a competitive lending market, such situations are unlikely to arise. The lender demanding unreasonable security cannot compete for very long.

Secondly ,the monopoly argument overlooks that in the case of a dealer's stock-in-trade, it will usually be to the dealer's positive benefit if the law should allow a present security to secure future stock. He will be able to accomplish the continuance and expansion of his business more easily than he can under the presently available floating charge which requires him to incorporate. Furthermore, there are situations where a lender will be fully justified in refusing to finance unless he is the only secured creditor, e.g. the grocery wholesaler financing the retail grocer. A law which allows or even encourages one secured creditor to exercise a considerable amount of control over his debtor with regard to the financing of his stock-in-trade is not necessarily bad. Indeed, the intelligent dealer will often tie himself to one major financer for his own protection since the latter will find it difficult, as a matter of business morality, to desert him in times of trouble.

To counter the possibility that the recognition of securities over future goods could become a straightjacket upon a dealer's ability to engage subsequently in further financing, appropriate limitations could be written into any amending legislation to avoid undesirable or unjust results. One such limitation could be the introduction of the American concept of a "purchase money security interest", whereby sellers of goods or persons giving value to enable a dealer to purchase those goods, can take a security interest therein which will also extend to identifiable proceeds of sale, and which will take priority, under certain conditions, over a conflicting security interest arising under a wide after-acquired property clause. The concept of the "purchase money security interest" will be explained in more detail in the next section and at this stage it is sufficient to note that the general priority accorded to it would effectively dispel any danger that the recognition of a dealer's power to grant securities over his future stock would make impossible any subsequent secondary financing with a new lender.

There is also the argument of *fait accompli*. Dealers have long been able to grant securities over their present and future assets by incorporating and then executing floating charges. This requirement of incorporation is one that persists only through sheer inertia and without foundation in principle. It is no longer fair to force all the

attributes and duties of a company upon a dealer so that he can obtain the necessary finance to continue in business; the administration of a company can be quite a technical business for which many dealers, without the aid of professional advice, are not equipped to cope. It has been stated that of the first 1000 companies registered in Auckland in 1968, 997 were private companies and of these 962 had less than five shareholders.[9] Can it therefore be reasonably suggested that public policy requires more protection of the private trader than the private *incorporated* trader?

Finally, in view of ss. 23 and 24 of the Chattels Transfer Act 1924, it can be seen that the policy argument that a borrower must be protected from committing himself too far into the future, has not carried much weight in this country.

The Rights of Unsecured Creditors

The third major factor to be considered in evaluating any proposed changes in the law relating to securities over future goods, is the rights to be accorded to unsecured creditors. It can be argued that if the law is to recognise such securities, the end result will be that, in practice, nothing will be left to satisfy their claims and consequently the sources of such credit will tend to dry up. In support of this argument the point can be made that ss. 23 and 24 of the Chattels Transfer Act 1924 were enacted so as to effectively immunise some of a trader's assets from the creation of security interests and thereby to reserve them for distribution to unsecured creditors in the event of the trader's insolvency.

It can be further argued on behalf of unsecured creditors that they are entitled to this reserve because, by extending credit along with secured creditors, they help keep a trader in business. If a private trader were to be allowed to grant a blanket charge over all his goods, no one would be safe in extending unsecured credit, thereby tending to close the door to this source of credit. Moreover, to require unsecured creditors periodically to examine public records to determine whether there is a registered security relating to a dealer's after-acquired assets would be too much of a burden to impose on them.

However, these arguments are only superficially attractive. If a secured creditor is allowed to claim $5,000 worth of assets on his debtor's insolvency, it is because at some stage he has in fact advanced this amount (or at least most of it where some interest remains unpaid). The above arguments overlook the obvious fact that when a loan of $1,000 is secured by $5,000 worth of assets, the secured creditor gets $1,000 not $5,000. There is nothing inherently fraudulent about a security over future goods insofar as unsecured trade creditors are concerned. The argument that unsecured creditors should be

9. Duncan and Molloy, "A Companies Commission" [1969] N.Z.L.J. 277, 281.

protected since they help keep the trader in business goes too far. It can be advanced against the recognition of *all* security interests and their respective priorities.

A refusal to recognise security interests in future goods would not somehow magically guarantee that stock-in-trade would be available upon insolvency for distribution among unsecured creditors. At any rate there is no justification for favouring unsecured creditors of traders in a way that unsecured creditors of other debtors are not favoured. They can often predict bad debt losses with reasonable accuracy and protect themselves by taking account of such losses in pricing their products.

There is also little weight in the argument that it is too great a burden to impose on unsecured creditors if they are required to examine a public register. Does a careful watch on retailer debtors require more effort than a watch on other kinds of debtors? Is this not an argument against the recognition of any registered security interests? Unsecured creditors should investigate the credit status of traders with whom they deal.

Obviously unsecured creditors must be protectd from fraudulent conduct on the part of secured lenders in enforcing their securities, but this does not at all necessitate a refusal to recognise securities over future goods. There is always the danger of fraud in all legitimate business activities, yet it has never been suggested that these activities ought to be stifled.

Furthermore, although unsecured stock-in-trade suppliers would risk losing that stock to duly registered security interests extending to the dealer's future stock, this does not mean that such securities ought to be altogether prohibited. Any proposed changes in the law should enable these suppliers to take a "purchase money security interest" in the stock they supply having priority over all other secured creditors.

There is also in this context the argument mentioned earlier of *fait accompli*. General creditors are not less likely to be deceived in the case of corporate securities than those granted by private traders. Finally, it is suggested that, since creditors who engage in unsecured lending necessarily do so on the strength of a customer's credit-worthiness (or the absence of any evidence of uncreditworthiness), one would not expect to find any significant reduction in the proportion of unsecured credit, however warmily the law was to embrace a security over future goods.

In view of the foregoing discussion, it is suggested that there are no policy reasons why securities over a dealer's future stock-in-trade ought to be altogether prohibited, although they do indicate certain limitations to avoid unjust results in some circumstances. Apart from those already mentioned, other arguments can also be raised in support of a change in the law relating to securities over future goods. First, the recognition of a more satisfactory device would enable stock-in-

trade financing to take place without the doubts and circuities of floor plans and other devices used at present.[10] Secondly, it would also facilitate the transfer of retail businesses since a buyer would no longer be forced into forming a company before he could finance the purchase, at least partially, against the security of the stock-in-trade. The advantage of limited liability to be gained by forming a company is no longer of practical significance as lenders invariably require personal guarantees from the principal shareholders.

IV. THE AMERICAN SOLUTION

Introduction

The development of chattel security law in the United States, and more particularly the law relating to securities over a dealer's stock-in-trade, took an entirely different course from that in England. By the end of the nineteenth century the security law of the various states had reached a state of complexity never matched in any of the other common law countries. It would be beyond the scope of this paper to enter into a full discussion of these complex and tortuous developments, and it is proposed to give a brief outline only.[11]

Throughout the nineteenth century it was generally speaking impossible in most states for a merchant or trader to grant an effective security over his stock-in-trade. The mortgage of stock-in-trade was invalidated on one or other of two grounds. First, many of the states refused to give effect to after-acquired property clauses. Although the decision in *Holroyd* v. *Marshall*[12] had been almost exactly paralleled twenty years earlier in the state of Maine,[13] the subsequent case law in the various states was, to say the least, conflicting and confusing. In some states it was recognised that an after-acquired property clause enabled future goods to pass in equity to the mortgagee as soon as they were acquired; thus, if the mortgage was registered pursuant to the operative chattel mortgage filing statute, the claim of the mortgagee prevailed over creditors and subsequent mortgagees. In other states, it was either necessary for the mortgagee to perform some "new act" or the after-acquired property clause was completely prohibited. Within these extremes there were many variations in approach.

Secondly, even in the states where the after-acquired property clause was recognised, the courts in varying degrees imposed limitations on the legal efficacy of a stock-in-trade mortgage. It was commonly regarded as either conclusively or presumptively fraudulent against creditors and purchasers alike.

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10. They are described by Sher and Allan, op. cit., n. 6.
11. For further details see Gilmore, *Security Interests in Personal Property* (1965) i, ch. 2.
12. (1862) 10 H.L.C. 191; 11 E.R. 999.
13. *Mitchell* v. *Winslow* (1843) 17 Fed. Cas. 527; for a detailed discussion of this case, see Gilmore, op. cit. 27-30.

Initially, the reason given by the courts for invalidating the stock-in-trade mortgage was that, since the mortgagor was permitted to remain in possession and to use some or all of the proceeds as his own, the transaction amounted to a fraudulent conveyance.[14] Later, some courts preferred the rationale that a mortgage which permitted the mortgagor to sell the goods and to divert the proceeds of sale was self-contradictory. There was something wrong or inconsistent about a mortgage of a changing stock of goods. Possibly at the root of the difficulty the courts had in accepting the concept of a mortgage of stock-in-trade was the notion that a security interest must be all or nothing — that if the mortgage was to be good against creditors it must be good against purchasers in the ordinary course of business. This analysis obviously missed the whole point of a security interest in stock-in-trade.

Several states enacted special statutory provisions dealing with the mortgage of stock-in-trade. Some of these were even stricter than the common law, others retained the common law restrictions. The law was far from uniform from state to state, and within the states themselves there was often a great deal of confusion as to the acceptable limits of a stock-in-trade mortgage. Furthermore, owing to the vastly different development of chattel security law in the United States, the English concept of a "floating charge" was unknown.

The failure of the law to accommodate legitimate business needs led to the invention of a number of ingenious devices aimed at enabling the dealer to finance his business against the security of his stock-in-trade. Some of these devices were successful and, "in the course of a generation, the transaction that had seemed to many courts inherently fraudulent in the guise of a chattel mortgage was, by the same courts, validated in the guise of a field warehousing arrangement, a factor's lien or a trust receipt . . . The law, by the process of indirection which is so offensive to logical purists, had once more achieved a sensible solution of a complex problem".[15]

Article 9 of the Uniform Commercial Code

This Article was introduced in an attempt to simplify and clarify the complex and unwieldly structure of security devices that had arisen in the United States during the late nineteenth and early twentieth centuries. The expressed aim of its framers was "to provide a simple and unified structure within which the immense variety of present day secured financing transactions can go forward with less cost and with greater certainty."[16] It replaces most of the pre-code common law

14. The notion that retention of possession plus a power of sale was fraudulent was traced back to *Twyne's* case 3 Co. Rep. 80b, 76 E.R. 809 discussed in Part One at pp. 123-125. See also Cohen and Gerber, "Mortgages of Merchandise (1939) 39 Columb. L.R. 1338, 1340.
15. Gilmore, op. cit., 46-47.
16. U.C.C., s. 9-101, Official Comment. References hereafter to the U.C.C. are to the 1972 Official Text published by the American Law Institute.

and statutory law governing the pledge, chattel mortgage, conditional sale, trust receipt, factor's lien, and the lease (where used as a security device). Traditional distinctions based largely on form are not retained. Where distinctions are necessary, they are made along *functional* rather than *formal* lines. For some purposes there are distinctions based on the *type* of property taken as security, e.g. business inventory and consumer goods. Where appropriate, Article 9 states special rules applicable to financing transactions involving these types of property. The old forms may still be used but the Code's single set of rules embraces them all.

Whatever the early law may have been, by the 1940's the chattel security law of most states allowed a debtor to use as collateral any part or all of his personal property including that to be acquired in the future. Yet, under this law, the parties were required to use a number of separate security devices such as the trust receipt or factor's lien and often the choice of the wrong one was fatal. Article 9 was designed to bring the law more into accord with business reality by enabling parties to security arrangements to accomplish more easily what they could only accomplish with some difficulty under pre-Code law.

Future Goods Under Article 9

It is not proposed in this paper to outline the procedure under Article 9 for the creation and perfection of security interests in personal property nor to get involved in a lengthy discussion as to whether Article 9 is capable of being exported into New Zealand law,[17] but rather to be less ambitious and concentrate on its solution to the problem of securities over future goods. As stated by one noted writer, "no previous security statute has so warmly embraced the once despised after-acquired property interest".[18]

Two provisions of Article 9 make it much easier to cover future goods when the initial security agreement is made. First, the public notice required to perfect a "non-possessory security interest" may be met by "notice filing". In contrast to s. 23 of the Chattels Transfer Act 1924, the Code only requires that the instrument to be filed (the "financing statement") give general notice that one of the parties has given, or even may in the future give, to the other a "security interest" in a class or classes of property which the former then owns, or may in the future acquire, to secure indebtedness that may at the time be outstanding, or may later be incurred.[19]

17. For a discussion of the exportability of Article 9, see Ziegel & Foster, *Aspects of Comparative Commercial Law* (1969) Part III.
18. Gilmore, "The Purchase Money Priority" (1962) 76 Harv. L.R. 1333, 1334.
19. U.C.C. s. 9-402. It is sufficient if the financing statement contains "a statement indicating the types . . . of collateral". Section 9-203 provides that the *security agreement* must contain a "description of the collateral" and the better view is that, at least in relation to after-acquired property the description need and can only be by types or kinds; see Gilmore, op. cit. 349-350.

Secondly, after-acquired property clauses are expressly validated in s. 9-204(1):

> "Except as provided in subsection (2), a security agreement may provide that any or all obligations covered by the security agreement are to be secured by after-acquired collateral."

The exception in subs. (2) relates only to consumer goods.[20]

When this strikingly brief provision is read in light of s. 9-203(1) under which the security interest can "attach" as soon as the lender has given value and the debtor acquired rights in the collateral, it becomes clear that the after-acquired property interest is one which arises automatically upon the acquisition of the future property by the debtor, and that it is not merely an *equitable* but a *legal* interest. This is confirmed by the draftsman's comment that

> "subsection (1) makes clear that a security interest arising by virtue of an after-acquired property clause has equal status with a security interest in collateral in which the debtor has rights at the time value is given under the security agreement. That is to say: the security interest in after-acquired property is not merely an "equitable" interest; no further action by the secured party . . . is required."[21]

The only other requirement is that the security interest be perfected by "notice filing" pursuant to ss.9-401 and 402.

This specific legal interest in future goods does not, however, prevail over all other competing interests. The buyer in the ordinary course of business must obviously take priority and this is provided for in s. 9-307(1).[22] Such a buyer "takes free of a security interest created by his seller even though the security interest is perfected and even though the buyer knows of its existence". If, however, the buyer actually knows that the sale is in violation of the security agreement, he cannot be a "buyer in the ordinary course of business" and thus takes subject to the security interest.[23]

20. No security interest in after-acquired consumer goods is valid unless the debtor acquires rights in them within ten days after value is given. The effect of this provision is very similar to the current proviso to s. 24 of the Chattels Transfer Act 1924, although, of course, there is no time limit under the latter provision.
21. U.C.C. s. 9-204, Official Comment 1. Although a security interest in future goods is said to have equal status with a security interest in existing goods, it is, of course, not the *equivalent* of a security interest in the latter. The debtor always retains the power to render the after-acquired property clause ineffective simply by not acquiring that property or by acquiring it subject to a "purchase money security interest".
22. "Buyer in the ordinary course of business" is defined in s. 1-201(9) as " . . . a person who in good faith and without knowledge that the sale to him is in violation of the ownership rights or security interests of a third party in the goods buys in ordinary course from a person in the business of selling goods of that kind but does not include a pawnbroker". "Buying" may be for cash or by exchange of other property or on secured or unsecured credit . . . "
23. This follows from the definition of "buyer in the ordinary course of business", supra.

Section 9-312(3) also provides for the priority, under certain defined conditions, of a "purchase money security interest" which is defined as one that is

"a) taken or retained by the seller of the collateral to secure all or part of its price; or

b) taken by a person who by making advances or incurring an obligation gives value to enable the debtor to acquire rights in or the use of collateral if such value is in fact so used."[24]

A purchase money security interest in inventory[25] has priority over a conflicting security interest in the same inventory and also has priority in respect of identifiable cash proceeds if a number of conditions are met. The purchase money security interest must be perfected at the time the debtor receives possession of the inventory. Also, the secured party must give written notification to the holder of the prior conflicting interest. This notification must state that "the person giving the notice has or expects to acquire, purchase money security interest in inventory of the debtor, describing such inventory by item or type".

The notification preserves the purchase money financer's priority with respect to not only the immediate transaction but any other transaction subsequently entered into. This is clear from the words "expects to acquire" and from the fact that the notification need only describe the inventory by "type". When the interest with which the purchase money security interest comes into conflict, is claimed under an after-acquired property clause by a lender who has made no new advance against the newly acquired property, the requirement of notification ensures that he has been advised of the true situation so that he will not subsequently be misled into making further advances in the belief that the new property is unencumbered.

As a result of the priority accorded by the above provisions of Article 9 to be the "purchase money" lender over the holder of a prior after-acquired property interest, any possible danger that the validation of a blanket after-acquired property clause will lead to a lending monopoly and thus render impossible any subsequent secondary financing with a new lender, is effectively dispelled.

It is suggested that, bearing in mind the writer's conclusions on the policy considerations discussed in the previous section, the above provisions of Article 9 provide a suitable basis for reform in New Zealand. Particularly if these provisions are compared with the presently available floating charge, it can be seen how the deficiencies of the latter would be overcome by adopting, in principle, the American solution.

First, the Code security interest in future goods is available whether the debtor is an incorporated company, a partnership or an individual.

24. U.C.C., s. 9-107.
25. "Inventory" is the American term for stock-in-trade.

Secondly, although the security interest in future goods is described in the Official Comment to s. 9-204 as "floating", it is, as noted earlier, a fixed or specific legal interest — one which arises automatically on the mere acquisition of the goods by the debtor. Whereas, the floating charge is really no security at all until some event occurs which causes the charge to crystallize. If the crystallizing event is, as it usually is, the appointment of a receiver, then any unsecured creditor who completes execution prior to that event will take priority over the charge holder. Under the Code the unsecured creditor would take subject to the lender's *specific* charge. Indeed, all questions of priority are dealt with in detail in Article 9 rather than depending on so variable a concept as crystallization.

Thirdly, the Code "purchase money security interest" enables a dealer to engage in secondary financing despite a previous charge extending to after-acquired property and, if the specified conditions are complied with, it will have priority over the previous charge. While the floating charge itself can be used for secondary financing, a prior floating charge will usually have priority. This is because most floating charges contain a provision prohibiting the company from creating further charges ranking in priority to or *pari passu* with the charge, without the prior consent of the lender, and a second chargee is deemed to have notice of this prohibition.[26] Even in the absence of such a prohibition, a first floating charge will have priority over a second floating charge where the assets comprised in both charges are substantially the same, although it may be postponed where the second charge affects a particular class of assets only.[27]

The Ontario Personal Property Security Act 1967

This Act is an adaption of Article 9 of the Uniform Commercial Code to Canadian conditions. It is a more succinct document then Article 9 and lacks the official comments. While there are differences in point of detail, the Act adopts the Article 9 solution to securities over dealers' stock-in-trade. Most important for present purposes however, it adopts the Article 9 solution to the problem of future goods. Section 13 validates the after-acquired property clause and s. 34(2) accords priority, under the specified conditions, to the purchase money security interest.

With the principles of the American and Canadian solution in mind, it is now time to examine how those currently proposing reform of the law relating to financing dealers' stock-in-trade in New Zealand intend to solve the problem of future goods.

26. Companies Act 1955, s. 102(12) and Chattels Transfer Act 1924, s. 4(2); see *Re Manurewa Transport Ltd.* [1971] N.Z.L.R. 909.

27. *Re Automatic Bottle Makers Ltd.* [1926] Ch. 412; see generally Pennington, *Company Law* (3rd ed. 1973) 373-374.

V. RECENT PROPOSALS FOR REFORM

A. The Legal Research Foundation Report

In 1970 the Legal Research Foundation published a report to the Contracts and Commercial Law Reform Committee in which its proposals for the reform of this country's chattel security laws are outlined and explained.[28] Part II of the report recommends certain changes in the law which it is hoped "will provide new means of financing dealers' stock-in-trade which will be useful to both companies and private traders".[29] These changes mainly concern the law relating to proceeds, protection of retail purchasers, future advances and future goods. Although all these matters are closely linked it is proposed only to examine here the recommendations with regard to future goods.

The Foundation begins by emphasising that "the amendments proposed in this report are stopgap measures designed to pave the way for the eventual introduction of an Article 9 type statute. To this end ,the amendments are designed to create, to the extent possible within the present framework, rights and procedures similar to those provided under Article 9".[30] Is this design in fact achieved?

The first recommendation of the Foundation is that "it would be desirable to allow private traders to give a security over stock-in-trade similar to a floating charge",[31] since it is unfortunate to force all of the attributes and duties of a company on a dealer merely because of the deficiencies in the Chattels Transfer Act 1924. It is said that this can be simply done by adding the following category of chattels to s. 26 of that Act (which at present exempts three categories of chattels from the operation of ss. 23, 24 and 25):

> "(d) Any chattels which the grantor contracts to hold on land or premises specified in an instrument by way of security where the grantor is a dealer engaged in the trade or business of selling or letting on hire chattels of such nature or description, provided that such chattels shall be described by brand or trade name or other mode of description so as to be reasonably capable of identification[32] and provided that the chattels of such nature or description are acquired from the grantee or that the grantee has given value to enable the debtor to purchase the chattels of such nature or description if such value is in fact so used."

This amendment will not apply where the dealer is a company because s. 2 of the Act excludes company charges from the definition of instrument. Although the floating charge is available to a company,

28. *Reform of the Law as to Chattels Securities (1970).* Legal Research Foundation Occasional Pamphlet No. 2.
29. Ibid., p. 12.
30. Ibid., p. 4.
31. Ibid., p. 5.
32. In the report the word "description" appears instead of "identification". This seems to be a misprint.

the Foundation takes the view that it is "completely satisfactory only when the creditor is providing all or most of the dealer's finance over a considerable period of time . . . It is quite inappropriate for secondary or limited financing."[33] Therefore, in order to put the company trader in a similar position to the private trader in this respect, it is proposed to add the following section to the Companies Act 1955 as s. 102A.

"(1) Any charge given over chattels by a company engaged in the trade or business of selling or disposing of chattels of such nature or description may extend to such chattels to be acquired by the company in the future, provided that such chattels shall be described by brand or trade name or other mode of description so as to be reasonably capable of identification and provided that the chattels of such nature or description are acquired from the holder of the charge or that the holder of the charge has given value to enable the company to purchase the chattels of such nature or description if such value is in fact so used.

(2) [this deals with "proceeds"]

(3) A company may create a charge to which section 102A(1) applies notwithstanding any term or provision expressed or implied to the contrary in any prior charge created by the company provided that [a floating charge] shall take priority over a subsequent charge to which section 102A(1) applies save where the holder of [the floating charge] consents in writing to the creation of the charge to which section 102A(1) applies.

(4) [This protects the bona fide purchaser at retail]

Since the final proviso to s. 102A(1) limits the scope of the charge to goods actually financed by the lender, it is envisaged that the floating charge will remain the more appropriate security for the lender (usually the trading bank) providing comprehensive financing for the dealer.

Although these amendments are intended only to be stop-gap measures and "an interim solution to one of the most serious problems in present New Zealand chattels security law",[34] it is suggested that they are unsatisfactory. They do not really create rights and procedures similar to those provided under Article 9 as is suggested by the Foundation.

The amendment to s. 26 of the Chattels Transfer Act 1924 does enable the private dealer to give a security over his stock-in-trade; however the security is restricted to lines of goods (or possibly even the dealer's whole stock-in-trade) that "are acquired from the grantee or that the grantee has given value to enable the debtor to purchase

33. *Reform of the Law as to Chattels Securities*, op. cit., p. 9.
34. Ibid., p. 12.

. . . if such value is in fact so used." The quoted words are adapted from the definition of "purchase money security interest" in Article 9 and are designed to prevent a lender from taking an excessive security; e.g. the manufacturer supplying one line of goods cannot take a security over all of the dealer's goods to secure payment. The Foundation takes the view that under the amendment, the grantee will "obtain security over the first lot of chattels acquired as well as any substitute chattels acquired with the first lot" but as presently drafted it is very doubtful whether the amendment achieves this. Where the grantee is the supplier of the original stock he will not have security over replacement stock purchased from a different supplier. It seems also that where the grantee is a lender who has advanced money for the purchase of the original stock his security will be divested as soon as that stock is sold. The replacement stock cannot be said to have been purchased from moneys advanced by the grantee; it will have been purchased from proceeds of sale.

Even if this interpretation of the proposed amendment is too restrictive, it is clear that it will only provide an appropriate security for secondary financing. It is envisaged that where the lender is providing comprehensive financing for the dealer, he will have to fall back on the floating charge for his security. Yet, no attempt has been made to remedy the deficiencies of the floating charge, viz, that it is available only to incorporated dealers and does not provide a specific legal interest in after-acquired stock. Clearly the rights and procedures created are not similar to those created under Article 9 which permits a dealer to give a security over all his future stock similar to a floating charge, but without the deficiencies of the latter in that it is available to incorporated and private dealers alike and provides the lender with a fixed legal interest in after-acquired stock — one which arises automatically on the acquisition of that stock by the dealer.

The Article 9 position is that while the grant of a security by a dealer over all his future stock should be recognised as valid, there should also be appropriate limitations to avoid undesirable or unjust results. To prevent the possibility of a lending monopoly and to enable the dealer to engage in secondary financing where required, priority is accorded, under certain conditions, to the "purchase money security interest" over a previous security agreement extending to after-acquired goods. This is a very similar security to that now envisaged by the amendment to s. 26 in that it enables, inter alia, the supplier of a line or lines of goods, or a lender who has given value to enable the acquisition of those goods, to take a security interest in them.

It is therefore suggested that while the amendment to s. 26 is some improvement on the present law, it does not go far enough. The writer agrees that to allow the supplier of one line of goods to take a security over all of the dealer's goods would be undesirable. Yet, where a lender provides comprehensive financing for a dealer a more satisfactory security than the floating charge is required.

A better solution to the whole problem of future goods in the context of financing dealers' stock-in-trade would have been to validate the Article 9 type "floating lien" which would enable the lender engaged in comprehensive financing to take a fixed or specific legal interest in all after-acquired stock of the dealer and which would be available to incorporated and private dealers alike. In order to avoid the danger that the validation of this type of charge might tempt some suppliers or lenders into taking excessive security, and to enable a dealer to engage in secondary financing where required, provision could be made for priority to be accorded, under certain conditions, to the subsequent holder of a purchase money security interest. One such condition could possibly be that the "purchase money" lender must notify the prior encumbrancer of his interest in the newly acquired goods so as to avoid the danger of the latter being misled into making further advances. It is suggested that in this way the competing interests of the lender providing comprehensive financing and the "purchase money" lender would be more equitably balanced than under the present proposals. Although the floating charge has worked surprisingly well in practice, and the business community at present seems to be satisfied with it, its deficiencies will probably be accentuated if the Foundation's recommendations are proceeded with.

If the solution proposed above was adopted then, ideally, the floating charge should be scrapped. However, it may have to be retained, at least temporarily. It has become such a popular and well-tried device that the business community would undoubtedly be reluctant to sacrifice it until the utility of the Article 9 type floating lien has been proved.

The proposed amendments to the Companies Act 1955 can also be criticised on the ground that the floating charge will remain the more appropriate security for the lender providing comprehensive financing. It is also suggested that the retention of the two-track system — one for companies and one for individual traders — will hardly aid the eventual transition to an Article 9 type statute. One register and one set of rules governing the permissible scope of securities and the protection of third parties would better aid such transition.

The Foundation states that the amendments to the Companies Act 1955 will "allow the dealer to engage in secondary financing even though he has executed a prior debenture secured by a floating charge".[35] Although the proposals are an attempt to ensure the availability of this type of financing, it is suggested that they will not necessarily have this effect. This is because the holder of a prior floating charge which contains a prohibition on the creation of subsequent charges will take priority over the holder of the "purchase money" charge, unless he has consented in writing to the creation of that charge. Again, the rights created are dissimilar to those under Article 9, where the priority of the purchase money security interest

35. Ibid., p. 11.

does not depend on the consent of the prior charge holder being obtained to the creation thereof. This restriction is further surprising since there is some precedent for the Article 9 position under the present law. An instrument over chattels which secures a loan with which the chattels are purchased is not subject to a prior floating charge, despite the prohibition on the creation of subsequent charges.[36]

Apart from these general criticisms as to the scope of the proposed amendments, the following more specific objections can also be raised.

First, the amendment to s. 26 of the Chattels Transfer Act 1924 will apply only to chattels "which the grantor contracts to hold on land or premises specified in the instrument by way of security . . . " It is submitted that the quoted words are superfluous. The validity of the instrument does not depend on the goods in fact being held on the premises, so that if they are held elsewhere the grantee's security will not be impaired. Moreover, although bona fide purchasers at retail will be protected by an amendment to s. 19, other purchasers may be misled since, even if they have actual notice of the instrument, they may reasonably assume that goods not held at the specified premises are not subject to it. Nor can the "contracts to hold" language be said to facilitate identification of the goods subject to the instrument since they may in fact be validly held elsewhere than the specified premises. Also it is not clear to the writer how the "contracts to hold" language can be said to impose on purchasers other than at retail "a duty to inquire whether goods fitting the description in the instrument, although held at premises other than those specified in the instrument, are in fact covered by the security agreement", as suggested by the Foundation.[37] This would be their duty even if the "contracts to hold" language was deleted.

Secondly, the lender-grantee under s. 26(d) must initially give value to enable the dealer to purchase the described type of goods and such value must in fact be so used. This may result, at least in so far as the first lot of goods is concerned, in the lender, in order to be certain of his security, having to act as the paymaster of his debtor's creditors, a position which he may not entirely welcome. He will have to make his advance directly to the seller or by way of cheque to the seller's order, for if he pays over money to his debtor who some time later pays over a similar sum to his seller, there may be some difficulties of proof as to whether the value was "in fact so used".

The language used in s. 26(d) appears to stipulate that there must be the loan first and the purchase of the goods second or that both must take place simultaneously. Will the security be valid where say, the dealer acquires goods on Monday (on unsecured credit from

36. *Wilson* v. *Kelland* [1910] 2 Ch. 306; *Re Connolly Bros. Ltd. (No. 2)* [1912] 2 Ch. 25.
37. At p. 6.

the vendor) and the lender advances the price on Tuesday? The question here is whether a loan made *after* purchase of chattels can be fairly described as one made "to enable" the purchase. Or, to take a somewhat more difficult situation, what will be the position where the dealer pays the price or writes a cheque on Monday and borrows that amount on Tuesday? Two questions arise here — whether the loan can be said to have been given "to enable" the purchase and whether it has in fact been so used? Although in both these hypothetical cases a court could reasonably find that the requirements of s. 26(d) have been satisfied, it will nevertheless be advisable for a lender to make his advance either prior to or simultaneously with the purchase and to make it direct to the seller.

It is submitted that it would have been at least preferable to enable a dealer to give an effective security over any class of chattels in which he deals without the "purchase money" limitation, so long as that class is reasonably identified in the instrument. For example, why should not a grocer be able to give a security over say, his stock of tinned fruit and vegetables as it may be from time to time, whether or not it is given to the supplier, to a lender who is prepared to finance the actual purchase of that line of goods, or to any other lender?

Much of the difficulty with the Foundation's proposals stems from the fact that, in so far as the unincorporated dealer is concerned, the s. 26(d) purchase money security interest will be the *only* method of conducting stock-in-trade financing. Whereas, the Article 9 purchase money security interest in stock-in-trade was designed as a *limitation* on the effectiveness of a prior general after-acquired property interest, and as a method of conducting secondary financing, not as the only method of conducting stock-in-trade financing. The purchase money priority under Article 9 is essentially a "function of the degree to which the law recognises the after-acquired property interest as being fully perfected".[38] The American concept of the purchase money security interest in stock-in-trade has, therefore, been misapplied in the New Zealand context.

B. Report of the Contracts and Commercial Law Reform Committee

The Contracts and Commercial Law Reform Committee has recently published the first of a number of proposed reports on chattels securities which ,inter alia, suggests certain reforms relating to the financing of dealer's stock-in-trade. The report is framed as a commentary on the Legal Research Foundation's report and is a rather scanty document running to 14 pages.

The part of the Foundation's report which apparently caused the Committee most difficulty was its recommendations relating to future stock. At first it was decided to accept the Foundation's proposed

38. Gilmore, "The Purchase Money Priority" (1962) 76 Harv. L.R. 1333, 1370.

amendment to s. 26 of the Chattels Transfer Act 1924 but finally it was rejected. It is now proposed that the following less restricted category of chattels should be exempted from the operation of ss. 23 and 24 of that Act:

"(d) Any chattels which the grantor under an instrument by way of security is required by the instrument to hold, until sold or while not leased or hired, on land or premises specified in the instrument if —

(i) The chattels are of such a nature or are so described, whether by brand or trade name or otherwise howsoever, as to be reasonably capable of identification; and

(ii) The grantor is engaged in the trade or business of selling or of letting out on hire chattels of the same nature or description or of disposing of such chattels pursuant to hire purchase agreements."

This amendment meets some of the objections raised in the previous section by disposing of the Foundation's misconceived "purchase money" limitation, but it is still not an entirely satisfactory resolution of the problem of future goods. The amendment was designed by the committee to give unincorporated dealers power to validly charge their stock-in-trade similar to that at present possessed by companies. However, although it is broadly similar, the position of the unincorporated dealer will differ in one important respect. He will be able to create a specific charge over the whole or defined parts of his stock-in-trade. The charge will "attach" to the stock as soon as it is acquired by the dealer and it will prevail over all third parties except bona fide retail purchasers. From the lender's point of view it is a more effective security than the floating charge which does not attach until crystallization occurs.

The Committee envisages that the floating charge will remain the usual company security. Ironically, if the amendment is passed, an individual dealer will have *more* appeal security-wise to a lender than his corporate counterpart. Will we now see dealers being exhorted *not* to incorporate rather than the opposite being the case? Have we not gone from one extreme to another instead of leaving a dealer with a *choice* as to whether or not to incorporate his business?

A further difficulty with the committee's report is that no recommendations have been made dealing with the question of priorities between general charges over a dealer's entire stock-in-trade and subsequent charges over specific lines of goods. Apparently, the one dissenting member of the committee thought that this question ought to be dealt with immediately, but the report leaves it up in the air. The committee was content to say that the question of the unreasonable withholding of consent to a specific charge by the holder of a general charge will be referred to in its forthcoming report on Credit Contracts. But is not the first question whether a person who finances the acquisition of a particular line of goods and takes a security thereover

should have his priority depend on consent at all? The Committee goes from one extreme to another by first proposing that *all* securities granted by a private dealer over his stock-in-trade should be subject to the "purchase money" limitation and then rejecting the concept of a "purchase money security interest" altogether as a means of avoiding the admitted danger of one lender monopolizing a dealer's sources of credit.

The argument for the purchase money limitation on securities granted by private dealers was found by the committee to be "not unattractive".

> "Let us make it possible and simple . . . for the manufacturer of refrigerators supplying them to an electrical goods retailer to obtain a charge over the retailer's stock of refrigerators; but should such manufacturer not be discouraged from stipulating for a charge over the retailer's stock of washing-machines and electric frying pans as well?"[39]

The committee saw the danger of one lender taking excessive security if a blanket after-acquired property clause was validated, yet, at the same time, it also saw that it would be inappropriate to subject all securities granted over stock-in-trade by private dealers to a purchase money limitation. Lenders would simply continue to require dealers to incorporate and then grant a floating charge which is subject to no such limitation. The committee seems to have thought "either we legislate for the danger by limiting the initial security that can be taken in all cases or we do nothing about it at all". As the amendments stand, a lender who has registered an instrument securing a dealer's entire stock will take priority over all subsequent encumbrances. Even if another lender has advanced money to enable a dealer to acquire a new line of goods and has taken an instrument over those goods, the first lender will have priority to the extent of his outstanding advances. It is suggested that there was an easy way out of this dilemma which would have provided a suitable compromise of the competing interests involved. This was to validate the after-acquired propery clause but accord priority to any subsequent purchase money security interest.

Conclusion

It is difficult to see why an Article 9 type solution to the problem of future goods did not appeal to the Contracts and Commercial Law Reform Committee. Perhaps there was a reluctance on the part of some members to scrap the floating charge in favour of a new and untried security. This attitude is understandable because the floating charge, despite its deficiencies, has worked surprisingly well in practice and the business community seems to be reasonably happy with it. However, as mentioned in the previous section, there is no reason

39. Para. 6 of the report.

why it could not be retained until the utility of an Article 9 type charge is proved. The opportunity should have been taken to go at least some way towards ridding the law of the artificial distinctions between company and other securities.

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