SECURITY: SOME MYSTERIES, MYTHS, & MONSTROSITIES

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"Sometimes one is involved in the necessity of dealing with monstrosities."

— E. I. Sykes[1]

IDEAS AND UNIVERSALS — THE "THIRD MAN" SYNDROME

The thesis of this article is that many of the contemporary practical problems of security can not be satisfactorily resolved without a return, not merely to basic concepts of property and security, but also to basic philosophical concepts. These basics determine one's methodology; and if the basics are right, it may even be found that some of the problems are illusory.

For this reason, the study begins in ancient Greece.

Plato wrote that there is one ideal and real man made by God, and all men are merely images or copies of the "idea" of man; similarly with beds and with other tangible things, and also with intangibles such as concepts. For Plato, only the "idea" is real; the particulars are unreal, being merely copies of the "idea" of man, of bed, of beauty, and (if he had thought of it, he would have said) of security.[2]

Against this must be set the Aristotelian doctrine of "universals". To Plato, Aristotle replied that if there was one ideal man and one imperfect copy then, insofar as they had shared but not identical characteristics, there would have to be a third man of whom they were both imperfect copies, and so *ad infinitum*. Furthermore, as men are animals, there would have to be some further "idea" of which both the idea of man and the idea of dog were but imperfect copies.

For Aristotle, the reality is the universal, not the idea.[3] It is only because there are men that we can formulate a concept of manhood, and only because there are parents that we have a concept of parenthood. And, just as the characteristics of parents can change, so does the concept of parenthood. There is no such thing as an immutable "idea". This reasoning also can be

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[1] E.I. Sykes, *The Law of Securities* (4th Ed., Sydney, Law Book Co. Ltd., 1986) 5.

[2] Plato's doctrine of ideas or forms is developed most clearly in *The Republic* Vol. X 595B *et seq.*

[3] Aristotle *Metaphysics*. The criticism of Plato's Theory of Ideas is developed in Book I chaps. 6 & 9. Aristotle's own Theory of Universals is the subject-matter of the rest of the book.

applied to the concept of "security" — we have a concept of "security" because we have securities.

The conflict between the theory of "ideas" and the theory of "universals" still insidiously dominates much of our thinking today. The writer first became aware of its practical significance when he was assisting with the drafting of the *Alsatian Dog Act* 1962 of Western Australia.[4] Early drafts of the Bill defined "Alsatian Dog" in the terms of the Official Standard for Alsatian Dogs.[5] Fortunately, it was realised before the Bill became law that this definition was of the perfect dog — the "idea" of an Alsatian dog — and that there could never in practice be any dog to which it could apply. The Bill was suitably amended. Section 4 of the Act defines "Alsatian Dog" as:

> ". . . a dog of either sex wholly or partly of the Alsatian or German Shepherd dog breed and includes a dog determined as being an Alsatian dog under the provisions of Section 9 of this Act."

Section 9(1) provides:

> "The Chief Veterinary Officer . . . may determine that a dog, having some or all of the characteristics set out in the 2nd Schedule . . ., is an Alsatian dog for the purposes of this Act."

The 2nd Schedule contains the Official Standard.

The result can only be described as a vindication of the Aristotelians and a rebuff for the Platonists!

And so, it is submitted, should it also be with "security". Fundamental to most security problems is the dilemma whether there is a concept of security around which one can formulate particular securities; or whether one should look to the nature of actual securities and, by reference to their incidents, formulate the concept.

Zoologists and botanists assure us that all categorization is arbitrary and artificial. It is justifiable only because the human mind is incapable of embracing all manifestations of existence simultaneously; it is legitimate only as a convenient grouping of things or ideas that have some shared characteristics, and those characteristics must have common consequences so that the members of the category can, even if only for limited purposes, be treated alike. In all sciences, the dilemma is whether to define the category by reference to the observable characteristics or incidents of the "universals" or whether first to establish the category of the "idea" including its characteristics, and then to determine whether particular incidents or "universals" fall within the category.

The common lawyer should instantly recognise an affinity with this dilemma in his own discipline. Categorization is not natural to the common law process and often is misleading and dangerous. But for the civilian, immersed in his Codes, categorization is the essence of legal reasoning.

In Civil Law Codes, concepts are clear and well-defined; in Platonic terms, the "ideas" are in place. The civil lawyer knows the difference between pro-

[4] Act No. 89 of 1962 (W.A.).
[5] Promulgated by the Kennel Club of Great Britain.

perty and obligation, betwen immovables and movables, between security and contract, and this enables him to move from those concepts to deal with observable phenomena.[6] He knows also the forms of security, which are permissible under the Codes — generally hypothec for immovables, pledge for movables. The categories of real rights are closed and further attempts to achieve the functions of security can be effective only as part of the law of obligations. These attempts can not create proprietary or real rights.[7] Once the characterisation of a transaction is made, the incidents of the transaction follow from that characterisation. If this is a hypothec, then these are its legal incidents or its legal consequences. But if it is a sale, then there will be a different set of incidents or consequences. It is suggested that the same methodology characterises the American *Uniform Commercial Code.*

By contrast, in the common law there are no definitive and authoritative statements of the categories, but instead 1000 years of evolution marked by judicial pronouncement, some statutory modification or consolidation, and academic restatement or systematisation. The common law has purported since the time of Bracton[8] to recognize a distinction between property and obligations but, perhaps because of Bracton's focus on remedies rather than on concepts, it is not clear what it is. It has never really solved the conundrum that the corollary of obligations is rights, but all property is a matter of rights. It has never satisfactorily classified either property or rights. The distinctions between real and personal property and between *choses in possession* and *choses in action* lack any validity other than the purely historical. The common law recognizes security but cannot define it except in relation to its functions, with the result that in the common law there is no correspondence to the *numerus clausus* of the civil law.

It would be difficult to say whether these differences between the two major systems of law stem from their different methodology or whether they have brought about the differences in methodology. But the process of legal reasoning of the two systems is different. While the civilian starts with concepts and, having ascribed the transaction to a concept or category by reference to its form, is able to identify its incidents, the common lawyer first identifies the incidents and, by reference to these, is able to assign the transaction to a category.[9] But it follows from this that the characterisation of the

[6] One of the classic expositions of the Civil Law methodology is that by Sumner Lobingier "Juristic Acts in the Civil Law" (1949) 24 *Tul. L. Rev.* 178.

[7] The difficulties that this rigid definition of the forms of security (or *numerus clausus*) causes in many of the civil law jurisdictions of Asia has been examined in the 11 vol. series *Law and Development Finance in Asia* (St. Lucia, UQP, 1973–80) D.E. Allan, M.E. Hiscock, & D. Roebuck (Eds).

[8] Henry de Bracton (Justiciar to Henry III in the 13th century) whose book *De Legibus et Consuetudinibus Angliae* was more concerned to catalogue remedies available in the King's courts than to compile a list of rights of property.

[9] The same division appears between English and continental philosophers. Bertrand Russell *History of Western Philosophy* (London, George Allen & Unwin Ltd, 1946) at pp. 668–9 observed: "In Locke or Hume, a comparatively modest conclusion is drawn from a broad survey of many facts, whereas in Leibniz a vast edifice of deduction is pyramided upon a pinpoint of logical principle. In Leibniz, if the principle is completely true and the deductions are entirely valid, all is well; but the structure is unstable, and the slightest flaw anywhere brings it down in ruins. In Locke or Hume, on the contrary, the

transaction is of less importance to the common lawyer than to the civilian because, having already settled the incidents, the descriptive label he attaches has few consequences. Hence the common lawyer's traditional question when asked, for example, whether a transaction is a security — "Who wants to know? — and why?" In the context of credit and security, the attachment of the label "security" rather than "contract" may be relevant only in relation to statutes which either tax or provide for the registration of "securities" or in relation to contract provisions such as borrowing limitations or negative pledge clauses which limit the right to provide further "securities".

The common law today does undoubtedly have a theory of security, but this theory has to be deduced from the interaction of common law and equity. Unfortunately, what has tended to happen, particularly over the last hundred years, has been the distortion of the interpretation or systematisation of this interaction by the intrusion of alien concepts from the civil law. The process, which through the influence of Canon Law had always been concurrent with the common law, accelerated with the abolition of the forms of action and the consequent need to identify, classify, and correlate legal principles. It is no accident that this coincided more or less with the inception of the systematic study of common law in universities. And it is true that the most important aspect of the role of the university lawyer is to systematise the mass of data from decided cases, to reconcile it with any relevant legislation, and to enunciate the emerging legal principles. But it is important that this process of systematisation should not be forced into the structures and concepts which are not endemic in the common law. Yet, at the time when the process started in the universities in England, jurisprudence in Germany and France in particular had developed to a high degree of sophistication. It was not, therefore, surprising that university teachers of law in England looked to and were influenced by continental models.[10]

In relation to the area of security, the continental influence made its greatest impact through the drafting of Article 9 of the *Uniform Commercial Code* in the United States. This was the work of Karl Llewellyn, himself German-trained. It is ironic that Llewellyn's declared intention in preparing Article 9 was to escape the conceptual dominance of German law and to relate the Code to external factors. Nevertheless, and although Llewellyn would probably have denied it strenuously, German methodology exerted a considerable influence on Article 9.[11] This is not to detract in any way from the merit of Article 9. It is a realistic and extremely functional approach to the whole problem of secured financing. But it is in no way a restatement of the common law. Nevertheless, it is submitted that it is a model that could be adopted

base of the pyramid is on the solid ground of observed fact, and the pyramid tapers upward, not downward; consequently the equilibrium is stable, and a flaw here or there can be rectified without total disaster."

[10] For an illuminating discussion of the interaction of common law and civil law concepts and methodology in the law of contract, see B. Nicholas "Rules and Terms — Civil Law and Common Law" (1974) 48 *Tul. L. Rev.* 946.

[11] For an account of Llewellyn's drafting of Article 9 of the U.C.C. and the influence of civil law, see Shael Herman "Llewellyn the Civilian: Speculations on the Contribution of Continental Experience to the Uniform Commercial Code" (1982) 56 *Tul. L. Rev.* 1125.

easily and with advantage in most common law jurisdictions.[12] An Article 9-type security has been adopted in Ontario.[13] In England, the Crowther Report on Consumer Credit strongly urged the adoption of an Article 9-type security;[14] and more recently the Diamond Report on the reform of the law relating to mortgages, charges, and other interests over property other than land has made similar recommendations.[15] In Australia, in 1972 a Committee of the Law Council of Australia (the "Molomby Committee") reported on "Fair Consumer Credit Laws". This report recommended a broad Article 9 security. A Conference in 1972, hosted by the Monash University Law School and the Australian Finance Conference, considered the Molomby proposals in detail and made recommendations to the Standing Committee of State and Commonwealth Attorneys-General favouring the adoption of the proposals.[16] There then followed many years of lobbying and whittling down of the proposals, largely by those sections of the finance industry which failed to appreciate how much in terms of efficiency they stood to gain from the proposals; and there eventually emerged at the end of the tunnel the *Credit Acts* 1984 (Vic., N.S.W., W.A.), the *Credit Ordinance* 1985 (A.C.T.) and the *Chattel Securities Act* 1981 (Vic.) which subsequently had to be replaced by a completely redrafted *Chattel Securities Act* 1987 (Vic.). Any resemblance between this legislation and Article 9 of the U.C.C. (or even of the Molomby proposals) is minimal. The present law in Australia is conceptually complex and obscure, and commercially unworkable. It is baffling to lawyers, financers, and consumers alike. Worst of all, it is not uniform.

The writer personally deplores the failure in Australia to adopt a rational and workable version of an Article 9 security. Apart from direct adoption, however, Article 9 has influenced legal scholars and legal thinking in many common law jurisdictions. But, it is the submission of this paper, that this indirect influence as distinct from open adoption has exercised a subtle and distorting influence on the formulation of principles of security in both Australia and England. In particular, recent years have seen emerge a methodology and a conceptualisation of security that sits more comfortably within continental jurisprudence or Article 9 than it does within the common law.

Concepts, characterisation, categorisation and methodology are all important. If they are not correct they will have significant practical consequences. As to what is "correct", it is submitted that, while legal principles must be

[12] See J.S. Ziegel and W.F. Foster, *Aspects of Comparative Commercial Law* (Dobbs Ferry, N.Y., Oceana, 1969). Chapters 21–25 contain a series of essays on the question "Is Article 9 of the Uniform Commercial Code Exportable?" See also R.M. Goode "The Modernisation of Personal Property Security Law" (1984) 100 L.Q.R. 234 for a cogent argument for the adoption of an Article 9-type security.

[13] *Personal Property Security Act* 1967 (Ontario).

[14] The Report of the Committee on Consumer Credit (Cmnd. 4596) (London: H.M.S.O., 1971) paras 5.7.20 *et seq.* It is common knowledge that this section of the Report, which strongly urged the adoption of a new security law along the lines of Article 9, was drafted by Professor Goode.

[15] Published by the (U.K.) Department of Trade and Industry on 27 January 1989.

[16] The Conference papers were published in book form as *Consumer Credit: the Challenges of Change* (CCH, 1972).

flexible and have a capacity for growth and development, to state them within a format borrowed from an alien system does not promote that growth and development; on the contrary, it is more akin to a strait-jacket stunting and inhibiting free development.

In this article, it is proposed to explore some of the mysteries and myths which the writer believes have appeared over the years in our formulation of the principles of security and which have hindered their useful growth.

WHY SECURITY?

An examination of the concepts and methodology of security should begin with an enquiry as to what is expected of security, what is its purpose and function. Only if we know why creditors seek security can we answer some of the more complex questions that follow. Yet it is here that some of the myths and mysteries begin.

The usual explanation of why security is taken by a creditor is that it provides the creditor with an alternative source of recoupment if the debtor either can not or will not pay voluntarily.[17] On the other hand, the writer has suggested elsewhere[18] that this is only one of several functions, including the commitment of assets of the debtor to the success of the enterprise or purpose for which he borrows. It is likely today that security in many cases is taken as a matter of course by a creditor or lender because it is the traditional and accepted method of financing, but without considering whether the expense justifies the return.[19] In relation to development and commercial financing, the writer has asked elsewhere how it is possible through security to achieve the object of providing an alternative source of repayment of loans totalling as much as $3 billion.[20] In relation to smaller commercial or private financing, it may be asked whether it is not as efficient, on default by the debtor, for the creditor to seek summary judgment and move immediately to execution against the assets of the debtor. This device should become more attractive today with the increased willingness of the courts to preserve the assets of the debtor for the benefit of his creditors through the *Mareva* injunction.[21]

[17] See for example R.M. Goode *Legal Problems of Credit and Security* (2nd Ed., London, Sweet & Maxwell, 1988) 1; E.I. Sykes op. cit. 1. Hereafter "Goode" & "Sykes" respectively. An extended version of Goode's views can be found in his article "Is the Law Too Favourable to Secured Creditors?" (1983–84) 8 *Can. Bus. Law Jo.* 53, 55–6.

[18] D.E. Allan, M.E. Hiscock, D. Roebuck *Credit & Security: The Legal Problems of Development Finance* (St. Lucia, UQP, 1974) 58.

[19] A common justification put forward in favour of security is that, by reducing the risks, it makes the cost of credit less by reducing the interest payable. This may be so in some circumstances, although it is doubted if it is universally true. But security certainly increases the cost of setting up the credit and in many cases, particularly in large financial operations, it is incapable of substantially reducing the risk. In smaller consumer-type loans, the lender can probably achieve as much protection without resort to the expenses of taking security. Information and *locus standi* to intervene can be obtained through contract, and financial discipline can similarly be asserted.

[20] D.E. Allan, "Credit and Security: Economic Orders and Legal Regimes" (1984) 33 I.C.L.Q. 22, 28.

[21] A *Mareva* injunction is an interim or interlocutory injunction which restrains a party to litigation from disposing of specified assets or from removing them from the jurisdiction.

However, if one confines one's enquiry to traditional channels, it should be recognized today that the principal value of traditional security is to give the creditor a preferred position in the insolvency or liquidation of the debtor. The major fear of creditors is the insolvency of the debtor and the risk that the creditor will have to line up and share *pari passu* with all other creditors. Security provides a means whereby, in the event of this catastrophe, the secured party can make off with the assets against which he is secured and satisfy his claim in full outside the bankruptcy. Australian law at the moment permits a creditor to take this advantage through the means of legal security.[22]

This privileged position may not last. It is at variance with a legal policy manifested in the bankruptcy and winding-up legislation of seeking the rehabilitation of the debtor and, where that is not possible, of providing an even-handed distribution among creditors of all types. It concedes to any secured creditor the right to withdraw the assets against which he is secured and virtually to determine unilaterally that the debtor shall be put into bankruptcy or liquidation without reference to whether the situation of the debtor is salvageable and without regard to the interests of other creditors. The position is particularly acute so far as the unsecured creditors are concerned,[23] except in the case of suppliers of materials or commodities to the debtor who may have protected themselves by some form of title retention clause such as a *Romalpa* clause.[24]

The Australian Law Reform Commission in its Report on Insolvency[25] stressed the need to support and strengthen the principle of equality of creditors and, noting developments along these lines in the bankruptcy legislation of the United States, the United Kingdom, and Canada, has recommended a compulsory moratorium period on the rights of secured creditors to enforce their security against insolvent companies, with a view to maximising the value of the pool of property of the debtor. Briefly, unless the secured creditor takes steps to enforce his security within seven days of the debtor company's being put under voluntary administration, he will be unable to enforce the security for a period of at least 28 days (which may be extended) from the date the administrator takes control of the property of the company.[26]

In this way it assures the availability of assets for execution. It is so called because it first appeared in the case of *The Mareva* [1980] 1 All E.R. 213.

[22] *Bankruptcy Act* 1966 (Cth) ss.58 & 90; *Companies Code* 1981 s.438.

[23] For a comparative study of the relative positions of secured and unsecured creditors in bankruptcy in six countries, see *Securities and Insolvency*, D.E. Allan and U. Drobnig, (eds.) (1980) 44 *Rabels Zeitschrift* 615–807.

[24] A *Romalpa* clause is a form of title-retention security whereby a seller of goods seeks to "retain" an interest not merely in the goods sold but also in the proceeds of sale of the goods and possibly in any product manufactured from or incorporating those goods. See for example *Aluminium Industrie Vaassen B.V.* v. *Romalpa Aluminium Ltd* [1976] 2 All E.R. 552 and *Clough Mill Ltd* v. *Martin* [1984] 3 All E.R. 982.

[25] Report No. 45 "General Insolvency Inquiry" 1988.

[26] Id. paras 94–103.

Additionally the Report[27] recommends the abolition of the priority akin to a charge[28] which the Commissioner of Taxation may enjoy over debts owed to a taxpayer. The effect will be to take away from the Commissioner the ability to pre-empt a considered decision by the creditors generally and the liquidator and administrator. Also, in furtherance of the same policy, the Commission recommended[29] that title-reservation clauses should become registrable if they are to give a property or security interest effective in bankruptcy. Legislation along the lines of the Ontario *Personal Property Security Act* 1967 was recommended.

The effect of reforms such as these would seem to be to weaken dramatically the major argument in favour of taking security, at least in support of company finance. This may therefore be the perfect opportunity for financers and their lawyers to re-examine the question "Why security? — is it worth the cost?"

It is suggested that the starting point of such an enquiry is the examination of the risks (commercial, political, economic, natural) incidental to the particular financial package that is being assembled. When the risks are known, then ways of eliminating or reducing these risks can be assessed. Security is but one means: there are many more. Initial investigation and enquiry should be given high priority. Next, the drafting of the financing contract should contain such terms as may appropriately guard against perceived risks: representations and warranties, financial, accounting, and reporting covenants, events of default that indicate the likelihood of default and entitle the creditor to take steps to protect his investment, negative pledge clauses and rights of set-off. If it is simply desired to increase the size of the pool of assets from which the creditor can satisfy his claim, guarantees and secondary obligations of various descriptions should be considered. In the case of corporate financing, these may also serve to "tie in" the major shareholders and also suppliers or other customers of the enterprise who stand to profit by its success and who would not otherwise be personally at risk.

WHAT IS SECURITY?

As indicated above, for the common lawyer this ought to be an irrelevant question. Once the form of the transaction is identified and its legal incidents determined, it should not matter whether it is called a security or not. Many transactions are ambivalent: contractual set-off, sale with right of repurchase, flawed assets, subordination agreements, even leases may or may not be securities depending not on their form but on the objective intent of the parties as determined from the terms and context of their agreement. It becomes relevant to ask whether they are securities only in connexion with statutes or contracts which refer to "security" or "charges" but without

[27] Id. paras 707–9.
[28] Under the *Income Tax Assessment Act* 1936 s.218 and the *Sales Tax Assessment Act (No. 1)* 1930 s.38.
[29] Report No. 45 paras 752–5.

defining them more specifically. However, the question does continue to be asked and it therefore should receive an answer that carries some meaning within the common law.

It is submitted that to characterise a transaction as a form of security and then, in consequence of that characterisation, to ascribe certain incidents to it is not the common law method. The common law method should be first to examine the transaction itself and the incidents which the law ascribes to it or which the parties in the exercise of their autonomy have given it, and then, if necessary and appropriate, to characterise it as a security. The contest of methodology here is between inductive and deductive reasoning. In the common law neither can claim an innate superiority, and both are present. But it is necessary to understand how they work together. It is the writer's contention that common law (i.e. non-statutory) concepts are arrived at by a long process of induction; by the gradual perception that a series of instances are linked together to form a whole. But, in a mature legal system, this concept arrived at by an inductive method may be treated as absolute for a while, and the process of legal reasoning becomes deductive, until cases arise which are seen to qualify the concept — whereupon the inductive process is rekindled until a new concept is perceived.

It is further submitted that the criterion to be applied to determine whether a transaction is a security, after its incidents have been determined, is its ability to fulfil the function of security. Anything that performs the function of security must be a security. The issue therefore becomes the problem discussed in the previous section of this article: what is the function of security?

If the function of security is the reduction or elimination of risk, then everything described above as performing this function is security. If the function of security is to increase the pool of assets out of which the creditor may satisfy his claim, then we should include guarantees and all other forms of third party obligations within the definition of security. If we take the narrowest view and say the function is to enable the creditor to satisfy his claims out of specified assets of the debtor if the debtor defaults, then we are talking about property as security, about rights *in rem* which can be asserted against all other claimants independently of contract. It is fortunate that the question rarely has to be asked, but which view one takes must depend on the construction of the statute or contract for the purpose of which one has to ask the question.

For the purpose of this article (which is concerned with some of the problems encountered with property security), "security" is taken in the narrowest sense discussed in the previous paragraph, namely "security over property" or security which does confer on the secured party certain rights in specified property which can be asserted against strangers to the transaction.[30] So one starts with a transaction between the secured party and the party giving

[30] This is often referred to as "external validity" of the transaction, as compared with "internal validity" which refers only to the validity *inter partes*.

the security.[31] What incidents have the law or the parties to the transaction given to it? Does this form of transaction give the secured party rights which are enforceable not merely against other parties to the contract but also against non-parties? The particular rights which would justify the classification of the transaction as a security are sometimes known as rights of preference and pursuit in respect of specified assets or classes of assets.[32] The right of preference embraces priority but is wider. It is the right of the secured party to pay his claim out of the secured assets or their proceeds in priority to both the general creditors and other secured creditors against whom he has a prior claim under the rules of priority, whether statutory, legal or equitable. The right of pursuit is the right of the secured party to follow the asset into the hands of third parties who may have received it or taken it from the party giving the security and to satisfy his claim out of that asset in their hands.

These two rights of preference and pursuit are at the very heart of the matter. If one is trying to create or establish a security, or if one is trying to characterise a transaction as a security, these are the rights one seeks. It should follow that a form of transaction which confers these rights on the creditor is a security;[33] and a transaction which does not (given the premise in this section) is not a security. How one identifies these rights raises clearly the dichotomy of deductive and inductive reasoning: on one view there are rights of preference and pursuit because the form of the transaction is a security and creates real rights; on the other view it is a security conferring real rights because the parties have agreed to create rights of preference and pursuit and have complied with any prescribed formalities. The former view impels towards the view that there is a *numerus clausus* of securities in the common law; the latter falls back on party autonomy.

What do the text books say? It is, of course, impossible to write a textbook without defining the subject-matter. The danger is that the writer then locks himself into a concept which should be the conclusion rather than the beginning of his enquiry.

Goode[34] states:

> "A security interest is a right given to one party in the assets of another party to secure payment or performance by that other party or by a third party. A security interest:
> (1) arises from a transaction intended as a security;
> (2) is a right *in rem*;
> (3) is created by grant or declaration of trust, not by reservation;

[31] The party giving the security will not always be the principal debtor. It is not uncommon for directors or major shareholders of a company, or related companies, in addition to giving personal security in the form of guarantees, etc. of the company's obligations, also to give security over their own property.

[32] There is a discussion of the incidents of security in R. Goode, *Commercial Law* (Harmondsworth, Penguin Books/Allen Lane, 1982) at p.733.

[33] An absolute sale also would confer rights of preference and pursuit, but the problem here is examined as between debtor and creditor.

[34] Goode, op. cit. 1 *et seq.* In fairness to Professor Goode, it should be understood that this definition is not his ideal but rather how he sees the present state of the unreformed law. As indicated above, Professor Goode has for many years been at the forefront of the campaign for the modernisation of what he sees as outmoded concepts within which secured financing in England and Australia must operate.

(4) if fixed, or specific, implies a restriction on the debtor's dominion over the asset;
(5) cannot be taken by the creditor over his own obligation to the debtor."

To limit the enquiry at the outset, item (5) can not be part of the definition; it is, if true, a consequence of the characteristics of security defined in the previous elements. Item (4) adds nothing to the definition. It is merely a consequence of (2) and (3). It is therefore on (1), (2), and (3) that one must concentrate.

It is interesting that Goode starts with a definition of a security interest rather than security. He asserts what must be axiomatic if one is talking about property security, namely that it creates rights *in rem*. But he says that it arises from a "transaction"; and the question "what sort of a transaction?" is answered by saying it is a transaction that is intended as a security. It would be easy to say that this begs the issue; but, for present purposes, we can take it as a transaction that is intended to create rights *in rem*.

Sykes,[35] by contrast, says "the security is not the transaction; it is the interest or aggregation of rights which arises from such transaction." He then characterises the rights as "real" in the sense "of involving rights *against* such res and not merely against a person." Although it is clear from what follows that Sykes in fact is describing the rights of preference and pursuit, it must nevertheless be demurred that his definition misses the critical quality. A right *in rem* is not a right *against a res*, which would be as much an absurdity as a right to slam the door or to kick the cat; it is a right *in respect of a res*, which can be asserted against third parties. This right is a characteristic of security, rather than a result of characterising the transaction as creating a security. However, for Sykes,[36] preference and pursuit are results of the right of the creditor. He says:

> "The fact that the security holder may resort to his security and . . . not be affected by the bankruptcy is a basic phenomenon but is a result rather than a characteristic. It can rarely be used as a test to see whether a security interest exists, because very often the question of the effect in bankruptcy is the very matter to be decided by the court."

What this overlooks, however, is that the right of the secured creditor to withdraw assets is, as we have seen, conferred expressly by the *Bankruptcy Act* and, for this purpose, the *Bankruptcy Act* defines a secured creditor in transactional terms as "a person holding a mortgage, charge or lien on property of the debtor as security for a debt due to him from the debtor."[37]

To return to Goode's definition, Goode sees a security interest as "a right given to one party in the asset of another party to secure payment or performance . . .",[38] and sees it as the result of a transaction. That result has the

[35] Sykes op. cit. 3 *et seq.* (emphasis in original).
[36] Op. cit. 4.
[37] *Bankruptcy Act* 1966, s.5(1). It is conceded that for the purpose of this statute there is a *numerus clausus* of securities, but that is only because the statute creates it for that purpose only.
[38] Op. cit. 1.

five characteristics listed above. It is suggested, however, that the basic premise is flawed. If one asks why Goode wishes to know whether it is a security, the only answer can be that it is to establish whether it has the basic characteristics which he says are part of the definition. The alternative approach, which is preferred by the writer, is to look at the transaction and to determine by the ordinary canons of construction what are its characteristics. If it has certain postulated characteristics (or perhaps only some of them), you can call it a security if you wish; but the only reason for doing so is to comply with some statutory or contractual requirement expressed in terms of security but otherwise undefined. The "security interest" consists of those rights in connexion with property which are enforceable against strangers as distinct from contracting parties.

Goode says that the transaction must be intended as a security, and says this has both positive and negative aspects.[39] There is no difficulty with the positive aspect, namely that a transaction intended as a security will be treated by the courts as a security even though it is in form an outright transfer. However, there is some difficulty with the negative aspect, namely that a declaration by the parties that they do not intend to create a security will be effective "even if it may appear at first sight to have an affinity with security." This may be stated too broadly. Whilst the writer is able to agree in general terms with the examples that Goode gives (sale and lease back, and sale of debts with recourse), it must be fundamental that if, on the true construction of the transaction, the parties have created the critical incidents of security (namely rights of preference and pursuit), then a denial that they intended to do this can not prevent its being a security. The intention of the parties is to be gleaned from the whole transaction, and if what has been done shows all the characteristics of a security, a bare express denial of the necessary intent is of no avail. It is only where there is some uncertainty how the provision should be construed that an express statement of intent is helpful.[40]

Goode's second characteristic of a security interest — that it is a right *in rem* — is obviously the key factor. But it should be observed that this means simply that the rights created are valid against third parties and, in our system, that depends not on a formal classification but on the particular incidents arising from the construction of the particular transaction. It is, to apply Sykes' terminology, a characteristic and not a result of security. Because of this, it is the third characteristic put forward by Goode — that security lies in grant or declaration of trust and not in reservation — that is the real bone of contention.

It is difficult to envisage how this third characteristic can be asserted after the first two. If a security interest "arises from a transaction intended as security" and if it "is a right *in rem*", what is the justification for limiting it in this way and ignoring the whole range of title-retention securities which play such a large role in both consumer and commercial financing? Goode forces himself into this position by his initial definition that a security interest is a

[39] Op. cit. 2.
[40] See *Palmer* v. *Carey* [1926] A.C. 703; *Swiss Bank Corpn Ltd* v. *Lloyds Bank Ltd* [1980] 2 All E.R. 419, affd [1981] 2 All E.R. 449.

right "given to one party *in the asset of another*", because in the title-retention securities the asset was and remains the asset of the creditor. But for Goode, the only securities presently available under English law are mortgage, charge, pledge, and lien.[41] Conditional sale, hire-purchase, *Romalpa*,[42] and financial leasing are all excluded. There is, if this is taken literally, a *numerus clausus* of securities in the common law essentially determined by the nature of the agreement, and if the agreement falls into one of those stated categories it is a security and as such carries with it the incidents of security. Goode acknowledges that in the *Uniform Commercial Code* the distinction between grant and reservation has been abandoned and any form of transaction which is intended by the parties to operate as a security will have the incidents and consequences prescribed by the Code. But, although he is influenced by the methodology of the Code in other respects and has championed the cause of the conditional sale, he baulks at this as a statement of existing law.

In the earlier editions of his book, Sykes took a similar view to Goode. But in the 4th edition, he was prepared to modify his stand: "In treating of securities in general, one has to face the fundamental difficulty of deciding whether to look entirely to legal forms or to adopt a wider functional approach which directs an enquiry as to the ends secured by particular practices and institutions."[43] The 4th edition included within its scope conditional sale and hire-purchase, although, alas, not financial leasing. It was Sykes' apologia that inspired the title and subject-matter of this article, and that may justify its quotation in full:

> "The writer in the first edition of this book decided not to treat either conditional sale or hire purchase on the admittedly technical ground that the concept of security was that of an interest in relation to another person's property. However, conditional sale represents a real transaction which involves the existence of a security and hire purchase represents the introduction of a financier in a fictitious form, viz. that of purchaser, rendered necessary by the desire to avoid inconvenient statutory provisions. Hire Purchase is a monstrosity not only by reasons of the fictions employed, but also because it involves a confusion between the concepts of sale and those of security. However, sometimes one is involved in the necessity of dealing with monstrosities. If the forms of law are bent to serve the needs of finding security for credit given, then the forms of the law must be examined and dissected."[44]

[41] Surely a declaration of trust is simply an alternative to transfer or assignment as a method of creating some types of security.

[42] Goode does point out that much of the danger and controversy surrounding the *Romalpa* clause can be seen in terms of whether it should be classified as a reservation or as a grant or equitable charge which would be invalid against the liquidator for want of registration: op. cit. 7.

[43] Op. cit. 5–6.

[44] Op. cit. 6. A victory for the Aristotelians — or nearly so; what is all this Platonic heresy about confusing the concepts of sale and security? Nevertheless, it should be acknowledged that on the road to Damascus Saul became Paul!

HOW DO YOU CREATE SECURITY?

Article 9 of the *Uniform Commercial Code* introduces four new concepts as stages in the creation of a security interest under the Code. These are: an *Agreement* to create a security; the *Creation* of the security interest; the *Attachment* of that security interest to the asset which is to provide the alternative source of payment; and the *Perfection* of that security interest against third parties.

These concepts do not have any direct counterparts in the common law. In common law systems one seeks simply a form of transaction, known to either the law or to equity, which creates or leaves in the creditor rights of preference and pursuit in respect of certain assets which are valid against third parties. Hence, in our system, apart from a few statutory securities, most securities are the creation of contract. The contract alone is generally sufficient to create rights and obligations between the parties which constitute a valid mortgage, charge, conditional sale, etc. In some cases there will be a preliminary contract to give security, followed by a more formal contract. This will generally occur when, depending on the nature of the property concerned and the form of security chosen, some formal act of transfer or assurance is required.[45] This may be conveyance, transfer, declaration of trust, assignment or delivery. But it should be remembered that a charge or an assignment are essentially the products of contract. When one considers title-retention securities, these will almost invariably be created by contract. Hence, in common law systems, agreement and creation may be separate stages; but creation of the security interest and attachment, in the sense of the creation of rights in respect of certain assets which are valid between the creditor and the person giving the security, will generally be concurrent. Even under a floating charge, whilst attachment to specific assets does not occur until the charge crystallises, attachment to a class of assets — or more accurately internal validity between chargor and chargee in respect of a class of assets — occurs on the creation of the charge.[46] The blunt truth is that the common law has never found occasion to be concerned with the concept of attachment.

Some separate act of perfection to give the transaction external validity against non-parties may or may not be necessary. This act may consist of taking possession of the asset or some indicia of ownership of the asset; it may consist of giving notice to third parties who control the asset; it may consist of a public act of registration. However, some transactions, particularly the title-retention securities, will have external validity without any further act. The secured party can retrieve the asset from receivers, liquidators, trustees or other claimants simply on the basis of his title to the asset.[47]

[45] In many cases, the agreement itself may be sufficient to create a security valid in equity without any formal act of transfer, grant or assurance which may be required by the common law — *Holroyd* v. *Marshall* (1862) (10 H.L.C. 191), 11 E.R. 999; *Tailby* v. *Official Receiver* (1888) 13 App. Cas. 523.

[46] This problem is discussed more fully below in connexion with the nature of a charge.

[47] The "reputed ownership" clause in bankruptcy never applied to company liquidations, and has been abolished in bankruptcy in Australia since 1966. However, in a modified form it may be about return in relation to company securities, because the Law Reform

Given this totally unsystematic pattern of security interests in the common law, one must doubt the validity of the valiant attempt by Goode[48] to express the common law within the conceptual framework of Article 9. This is not to deny that the logical simplicity of Article 9 would be an improvement on the existing system, but it is submitted that it will need more than the efforts of judges and legal scholars to achieve it.

Goode himself perceives the dilemma at the outset of his discussion of attachment. Having asserted that "the effect of attachment is that the security interest fastens on the asset so as to give the creditor rights *in rem* against the debtor himself, though not necessarily against third parties", he is immediately forced to confess that

> "there is admittedly something odd in the notion of a right *in rem* available only against the debtor, for that which distinguishes real rights from personal rights is supposed to be that the former affect not only the obligor but the world at large. . . . The purpose of the concept is to demonstrate that the debtor cannot dispute the conferment of real rights on the creditor, and the consequent restriction on the debtor's own dominion over the asset, but the same is not necessarily true of third parties. . . ."[49]

There is indeed something odd. A mere right to restrict the debtor's use of an asset can be supported simply by resort to contract rather than security. The oddity, as submitted earlier in this article, flows from the common law's refusal to equate rights *in property* with rights available *against all the world.* Roman Law equated the two and no problem arose. Civil law systems benefit from this direct legacy. But the common law, since the thirteenth century, has suffered from this doubt whether a right of property can exist which is not enforceable against all the world. The dilemma persists in the minds of those who seek to establish a jurisprudence of security in the common law, and creates for them difficulties which, it is submitted, disappear if the dilemma is seen as irrelevant. It is irrelevant because nothing turns on it unless one starts from a pre-conceived concept of security which one then equates with rights *in rem.*

The more important concept is that of perfection, because this is what may be required to give external validity to the security interest resulting from the transaction and make it a real right in the common law sense. Goode's attempt in the same chapter to deduce a coherent principle of perfection does not encounter the same logical difficulties as with attachment, but simply raises the question whether such disparity in the need for a separate act of perfection and the nature of the act required evidences any principle at all.

Commission Report No. 45 "General Insolvency Inquiry" paras 752–5 recommends a system of registration for title-retention securities.

[48] Op. cit. Chap II.

[49] Ibid. pp. 27–8.

THE DE-MYSTIFICATION OF POPULAR MYTHS

This article has tried to reassert three principles which it believes are basic to the notion of security in common law systems. These are:

(i) That one should not start the analysis of a legal problem by moving from a ready-made concept of security with pre-determined incidents; instead it is important to start with the examination of a transaction to determine what incidents the parties have given it or the law may impose upon it.

(ii) In common law systems, a rigid classification of rights as *in personam* or *in rem* is inappropriate and fruitless, particularly if rights *in rem* are defined as rights *in or against* property; instead one should ask whether one of the incidents of the transaction is external validity against non-parties, and this is what distinguishes it from contract.

(iii) It follows from (ii) that the concept of "attachment" of rights to assets is meaningless and misleading in the common law systems.

In the remainder of this article it is intended to apply these propositions to some of the major controversies which affect the area of secured financing today. It will be suggested that, if this is done, the problems may be found to be in large part illusory.

What then are the problems and difficulties?

What is a Charge?

If one sees security in terms of rights in respect of property available against third parties and not as rights *in* the property or *of* property, the charge (whether fixed or floating) becomes easier to explain, and the problems which surround it less mystifying.

Leaving aside statutory charges, the charge in origin was simply a right to be paid out of a designated fund or a fund produced by the sale or working of designated assets or a class of assets. It gave standing in equity to apply to the court for whatever relief was appropriate to see this was done — whether by an order for sale, the appointment of a receiver, an injunction, etc. Sykes contrasts the equitable charge with the equitable mortgage.[50] Whilst he sees the equitable mortgage as involving a division of ownership rights, he acknowledges the charge as "a pure hypothecation". The equitable chargee can never aspire to full beneficial ownership of the asset by reason of the charge; his only right is to an order for judicial sale in support of his *jus in re aliena.*

Goode, on the other hand,[51] sees a charge as an interest either in specific assets or in a constantly changing fund of assets. He acknowledges that Maitland characterised all equitable rights as rights *in personam,*[52] but says

[50] Op. cit. 190–96.
[51] Op. cit. 46.
[52] F.W. Maitland *Equity* (2nd ed., Cambridge, C.U.P., 1936); Lecture IX.

"to the modern equity lawyer the beneficiary has something more, a proprietary interest in a trust fund. . . . It can now be taken as settled that the floating charge creates an immediate interest *in rem*; what remains unclear are the nature and incidents of that interest."

This is certainly true of a security interest under Article 9 of the U.C.C. where even the floating lien gives the secured party a present interest in assets of the lienor while the assets fall within the description. But, in other common law countries such as Australia, it is misleading and it contributes to much of the uncertainty that today surrounds the charge, and in particular the floating charge.

One can not help believing that if common lawyers would stick to observable phenomena and avoid the use of Latin tags which the common law has never adequately translated, the position would be much clearer. Goode does cite[53] authority for six consequences of treating the floating charge as a present security interest. However, it is suggested that these do not go so far as to establish the floating charge as conferring "an immediate interest *in rem*" but merely relate to "external validity" or "perfection". The very debate indicates the hazards of debating labels instead of facts.

This confusion between real and personal rights in the common law and our inability to attach any settled meaning to the concepts is, it is submitted, the basic cause of much of the confusion and difficulty that now surrounds the charge as a form of security. If the charge, whether fixed or floating, is seen as giving rise only to personal rights, then the concept is much easier to handle.

The Nature of the Interest of the Secured Party Under a Floating Charge Pending Crystallisation of the Charge

In common law systems the floating charge is admittedly a present right of the chargee which does not affect particular assets within the scope of the charge until something happens to make the charge crystallise. It is clear that the chargee does have existing rights which are stronger than those of a person who simply takes a charge over future or after-acquired property. Goode, however, is bemused by the apparent logical inconsistency of a security interest that is a present security but which has not attached to any assets.[54] He appears to share the bewilderment of Civil lawyers with an institution that they can only describe as illogical and anomalous.

The present writer's bewilderment is simply as to why it should matter. Whatever the explanation for this phenomenon in the floating charge, all writers seem agreed as to the consequences or incidents of holding that the uncrystallised charge is a present security. These incidents are set out in Goode.[55] There may be some doubt about the breadth of the proposition that "the occurrence of the crystallising event causes the charge to attach without the need for any new act on the part of the debtor", largely on the ground of the

[53] Goode, op. cit. 50.
[54] Id. 47–50.
[55] Id. 50.

introduction of the concept of attachment which seems to prepare the ground for the notion of automatic crystallisation, which is discussed below. The major incidents are that the chargee, after crystallisation, has the rights of preference and pursuit in respect of assets disposed of by the chargor before crystallisation otherwise than in the ordinary course of business; that the chargee has status before crystallisation to seek relief from the court by injunction or appointment of a receiver if his security is jeopardised; and that the chargee's claim to assets will take priority over that of an execution creditor if the charge crystallises after the seizure of the goods but before the execution is complete.

It is submitted that the problems are largely the product of trying to fit the floating charge into an inappropriate conceptualisation. To ask whether the chargee has rights *in rem* or only *in personam* is surely a false trail. If the chargee's right is seen simply as a present right to be paid out of a certain fund on the happening of certain events and whatever that fund may consist of at that time, the problem disappears. Equity recognises and protects the chargee's right, and it will do so from the time of creation of that right.

Automatic Crystallisation of the Floating Charge

Similarly, to see crystallisation in terms of attachment is also misleading. It is true that, on crystallisation, the charge ceases to float and becomes fixed, but again this is figurative language. What happens in fact is that the composition of the fund which is the subject matter of the charge becomes defined. Until then, the composition of the fund can change by virtue of the chargor's power to deal in the ordinary course of business with assets that fall within the description of the fund. What really is in issue, if the process of crystallisation is to be understood, is the nature of the chargor's power to deal with the assets.

It is commonly argued that the chargor's power is in the nature of a licence to deal with the assets in the ordinary course of business until crystallisation occurs. This is an attractive theory if one accepts that an equitable charge has become a real right and not just a mere personal right. If the chargee has proprietary rights in the assets as a result of the charge, then he can license the chargor to deal with those assets on his terms. But, unfortunately, it is submitted that this is just what the chargee does not have. As argued above, the nature of his right is a right to ask the court to see that his claim is discharged out of a designated fund. The chargor remains the owner of the fund and the assets that comprise it. The charge is simply his acceptance of a restriction, which the court will enforce, on his ability to deal with the assets outside the ordinary course of business. The combination of that principle and the equitable doctrine of security over after-acquired or future property[56] constitutes the floating charge.

It is in this context that the nature of crystallisation should be examined. It is clear and fully accepted that the occurrence of certain events will automatically cause the fund to be defined and the restriction on the chargor dealing

[56] *Holroyd* v. *Marshall* (1862) (10 H.L.C. 191), 11 E.R. 999.

with its assets to become absolute. These are the company's ceasing to carry on business, the commencement of winding-up of the company, the appointment of a receiver out of court or the taking of any steps by the chargee to enforce his security. The instrument creating the charge may also provide for other events of crystallisation. What is in dispute is whether automatic crystallisation is limited to the first four events stated or whether party autonomy extends to providing for automatic crystallisation on any events the parties may choose.

The writer has for many years opposed the view that automatic crystallisation was an inevitable consequence of party autonomy. This was first because it seemed that it was rarely in the interest of the parties — the decision to put the company out of business should be a deliberate one — but secondly because party autonomy here seemed to conflict with the issue of legal policy which tries to preserve an ordered administration and distribution of assets on insolvency which was threatened if party autonomy was accorded the privilege of adversely affecting other creditors.

But the writer is now obliged to admit that the balance of judicial authority, after being equivocal for many years, has swung in favour of party autonomy.[57] Furthermore, if the writer's explanation of the floating charge is correct, then automatic crystallisation must be recognised as a consequence of the rule in *Holroyd* v. *Marshall*.[58] There is nothing in legal principle that would limit the right of the parties to declare the events on which a right will arise in the chargee exercisable against the chargor in respect of specifically or generically defined assets. This is entirely a matter of contract, in an area in which freedom of contract should be presumed in the absence of any legal ground for restricting it. What is anomalous is that, although the parties can by contract specify the event on which the fund will automatically be defined and the chargor's power to deal with the assets in the ordinary course of business will be curtailed, this will be effective against non-parties. The only explanation the writer can offer, and which he does not find completely convincing, is that on the happening of the specified event the charge, being registered, becomes a fixed charge and is perfected.

Goode[59] also accords the chargor and chargee complete autonomy as between themselves to determine the circumstances in which the charge will attach and become a fixed charge. However, he treats the issue of the effectiveness against third parties as a question of priority, governed largely by analogy with agency and with actual and apparent or ostensible authority. However, if the view of the nature of the charge propounded in this article is accepted, then it is clear that the chargor prior to crystallisation does not deal with the assets subject to the charge as agent for or as licensee of the chargee.

[57] In Australia, the latest authority in favour of party autonomy is *Fire Nymph Products Ltd* v. *The Heating Centre Pty Ltd* (1988) 7 A.C.L.C. 90. However, while the writer is now prepared to agree that a floating charge can be made to crystallise automatically on the happening of a specified event, he still begs leave to doubt whether it can be made to crystallise "immediately prior to such dealing". Re-writing history strains faith in party autonomy too far.

[58] (1862) (10 H.L.C. 191), 11 E.R. 999.

[59] Op. cit. 70 *et seq.* and 84 *et seq.*

He deals with the assets as beneficial owner. Admittedly he has accepted a restriction on his power to deal with the assets, but this can not affect the capacity in which he deals with them. Hence, no question of agency, licence, estoppel or, it is submitted, priority arises.

The problem may be about to become moot. The Law Reform Commission[60] has recommended that a charge should not crystallise until notice of crystallisation is given to the Corporate Affairs Commission or a receiver or the chargee has entered into possession of the property or a liquidator or administrator of the company has been appointed.

In the interest of completeness, it should be added that the view of the floating charge put forward in this paper would not prevent partial crystallisation of the charge. But de-crystallisation does begin to look like either a fresh charge or a licence to deal granted by a fixed chargee, and either of those might give rise to practical problems for the parties.

Can a Creditor Take a Charge Over His Own Obligation?

It will be recalled that the fifth characteristic that Goode ascribed to security[61] was the inability of a creditor to take a security interest over his own obligation to the debtor. To the horror of banks,[62] which as a matter of course had been taking a charge over customers' deposits to secure their overdrafts, and Commissioners of Stamp Duties,[63] this view has been accepted in England and in Australia. The justification, according to Goode, is that it is conceptually impossible because it would involve the proposition that a person (the chargee) would have to sue himself. Therefore, only a contractual set-off is a possibility.

It is submitted that the justification urged by Goode is not compelling; or even if it did have historical validity, it does not represent the present position. There is no reason why the effectiveness of the transaction should be dependent upon the ability of the chargee to sue himself; all that is necessary is that it should be lawful for him to pay himself! If legalism still requires that there should be a remedy before there can be a right, then it can be found in the willingness of equity to refuse to allow anyone to restrain the creditor paying himself. In effect, he simply cancels the debt he owes his debtor in full or *pro tanto*, as circumstances require, ahead of other claimants. To object that he could achieve the same result by a contractual set-off is beside the point. The form and the effect of the transaction need to be assessed, and it matters not that the same result could have been achieved by another form.

In any event, if Goode's reasoning is valid in the case of a purported charge, it would not seem to be valid if the form of transaction chosen is an assignment by way of security of the debt. If, for example, the bank's customer assigns the right to his deposit with the bank as security for his overdraft from the bank, this would appear to be a valid transaction. The *chose in action* represented by the deposit is an asset of the customer which can be sold or

[60] Report No. 45 paras 189–200.
[61] Op. cit. 10.
[62] *Re Charge Card Services Ltd* [1986] 3 All E.R. 289.
[63] *Broad* v. *Commissioner of Stamp Duties* [1980] 2 N.S.W.L.R. 40.

assigned by way of security to any creditor, including the bank. If the assignment is by way of security, no intention to merge and extinguish the claim and the debt could be implied.[64]

If it is objected that the *chose in action* which represents the deposit in the hands of the customer/depositor is not "property" but, like the charge, confers a mere right to sue the obligor, then again it evokes the question "but what is property in the common law?" The writer, again, does not think that the question has to be answered but, if it must, then it is submitted that "property" is to be identified by its characteristics rather than *vice versa*. "Property" then is something that can be transferred by sale or charge, through the legal mechanisms of transfer, assignment or negotiation. It can be conceded that the old common law would not have recognised the deposit as anything more than a right to sue in Debt. But equity by the eighteenth century was recognising assignments of debts and the law merchant negotiation of debts, so that by this time the attributes of property had been acquired. The introduction of a statutory form of assignment[65] makes nonsense out of any suggestion that a debt is a mere right to sue and as such can not be assigned absolutely or by way of security.

Sundry Other Securities

Questions arise whether set-off, subordination, negative pledge, etc. are securities. There is not space in this article to pursue all these enquiries. It is hoped that this article has demonstrated that the question "is it a security?" is the wrong question. The right question is "who wants to know and why?"; and the way to answer the question is to examine the particular right of set-off in the context of, for example, the statute that would tax it or make it invalid without registration or the contract that would seek to prohibit it. In most cases, after construing the statute or contract, the question is answered by asking whether the transaction will be given effect against third parties.

As for Title-Retention Securities

The writer will content himself with two comments in respect of leases, which are not securities under either the Sykes or the Goode definitions.

First, the *Chattel Securities Act* 1987 in Victoria includes in the definition of "security interest" ". . . any interest in or power over goods of a lessor, owner or other supplier of goods . . ."[66] However, as the principal purpose of the Act seems to be to provide for the "extinguishment" of security interests, this is a mixed blessing for secured lessors.

Secondly, whilst apart from this Act the law treats leases as a species of bailment, Accounting Standards[67] distinguish between operating leases and financial leases according to the economic substance of the transaction, and

[64] *Capital & Counties Bank* v. *Rhodes* [1903] 1 Ch. 631; *Re Fletcher* [1917] 1 Ch. 339; *Ingle* v. *Vaughan Jenkins* [1900] 2 Ch. 368.
[65] *Property Law Act* 1958 (Vic.) s.134.
[66] Section 3.
[67] AAS117, revised January 1988.

record them in the balance sheet accordingly.[68] And as Accounting Standards, since the amendments to the Companies Code in 1983,[69] now have the force of law . . .

AND SO . . .

This article has sought to demonstrate that, by trying to force the law into an unnatural framework and by applying the methodology of other systems, we may have created more problems than we have solved. On the other hand, if we can get the principles right, many of the problems are seen to be illusory. However, there are undoubtedly problems that raise policy issues, and controversy — particularly among different classes of creditors — is likely to surround these.

The biggest decision, however, is to recognise that a system of law that has grown over the centuries in response to a wide range of challenges at different times in different countries, is now uncertain, complex, perplexing, and unsatisfactory from all points of view. Australian law relating to secured financing at all levels urgently needs to be simplified on a uniform basis. The goals are efficiency, cost saving, security, and justice. It should not be necessary to resurrect disputes between Plato and Aristotle in order to fathom our own law.

If the U.K. can consider adopting a proper Article 9-type security, it may still not be too late for Australia to have yet another attempt — and this time to get it right.

POSTSCRIPT

Since this article was written, the case of *Bond Brewing Holdings Ltd* v. *National Australia Bank Ltd* has been decided in the Supreme Court of Victoria and leave to appeal refused by the High Court of Australia. The decisions have not yet been reported but the transcripts of the judgments are available. As the case has given rise to considerable speculation as to the future of unsecured or "negative pledge" lending, it seems this article would not now be complete without some further reference to the question posed above: "Why security?".

The action arose out of a financial package arranged for Bond Brewing Holdings Ltd ("BBH") of approximately A$1.6bn established by a Loan and Credit Agreement in 1986. The "package" consisted of –

[68] Whilst in Australia, the problem of distinguishing leases and secured sales has been delegated to the accountants who determine it substantially according to the location of risk, in America it has been tackled by seeking to introduce a new Article 2A into the U.C.C., which still focuses on the location of legal title rather than a risk-opportunity analysis. For this reason, categorisation still remains a problem in the United States. See Ivy Ozer "Article 2A of the Uniform Commercial Code: an Unnecessary Perpetuation of the Lease-Sale Distinction" (1989) 54 *Brooklyn L. Rev.* 1357.

[69] See now *Companies Code* Part IV Div. 1.

(i) a senior debt facility, provided by the consortium of banks, of A$880m repayable by instalments or immediately upon receipt of a notice of demand consequent upon the occurrence of an event of default; this facility consisted of –
  (a) a direct funding facility of A$600m, and
  (b) a "direct pay" letter of credit facility of up to A$280m in support of repayment of zero coupon bonds which were part of the package;
(ii) a zero coupon note issue of A$280m; and
(iii) a subordinated note issue ("Junk Bonds") of US$510m.

These funds were to be used by BBH to make loans, inter alia, to three breweries, each of which charged its assets in favour of BBH as security for the loans. BBH then irrevocably appointed National Nominess Ltd, which acted as Security Trustees for the consortium of banks, as its agent to exercise the power to appoint receivers under these charges.

The banks, which were otherwise unsecured, nevertheless obtained absolute priority over all other creditors of BBH and of the breweries (except for some few debenture holders of one brewery) by three means –

(i) the subordination agreement which was built into the financial package;
(ii) the taking of power through National Nominees Ltd to control the appointment of receivers of the undertakings of the breweries; and
(iii) a series of covenants, including negative pledge covenants.

The action was brought by the National Australia Bank Ltd ("NAB"), as agent for a consortium of banks, seeking the appointment of a Receiver of BBH. On the morning of Friday 29 December 1989, NAB gave notice of default based on alleged breaches of covenants over a protracted period and demanded immediate repayment of the money advanced under the senior debt facility. On the afternoon of the same day, Beach J. in the Supreme Court of Victoria granted the application *ex parte* and appointed receivers. In January 1990, after a hearing *inter partes* which lasted four weeks, Beach J. affirmed that appointment. BBH appealed to the Full Court of the Supreme Court of Victoria which unanimously (Kaye, Murphy, & Brooking JJ.) set aside the appointment. Subsequently the High Court (Mason C.J., Brennan & Deane JJ.) refused the NAB's application for leave to appeal from the decision of the Full Court.

Much attention has been given to this case in financial, commercial, and legal papers and journals, which have generally seen the result of the case as being the end of negative pledge lending. It is important, if negative pledge lending as we have come to understand it is to survive, that the reasons for the failure of the banks' move to put BBH into receivership be fully understood. Much of the misunderstanding seems to stem from the following passage in the judgment of the Full Court:

"... complicated covenants of a kind commonly called 'negative pledges', in which lenders have in recent years often placed their faith instead of

taking conventional security, sometimes to their regret. For recent experiences have shown lenders that all the covenants in the world are no substitute for good old fashioned security."

It is submitted that the judgments show little in the way of legal reasoning to support financial advice of such sweeping generality.

Without pursuing here a lengthy analysis of the judgment, it is submitted that what the Court did decide can be summed up in the following propositions:

(a) The Court does have an inherent jurisdiction to appoint a receiver of a company on the application of an unsecured creditor;

(b) Whilst it is not necessary that the creditor should have a proprietary interest in the subject matter of the receivership, it is necessary to satisfy the Court that an action at common law for recovery of the debt or for damages for breach of contract would not be adequate to protect the interest of the creditor and also that a receivership is a more appropriate remedy than, for example, the granting of an injunction;

(c) That the Court, in exercise of its discretion to appoint a receiver, will not normally appoint a receiver and manager of the undertaking of a company by way of establishing a regime to administer the affairs of a company in financial difficulties where the company opposes that course –

> "... while in a proper case it may be appropriate to use a receivership instead of an injunction to prevent the improper use of funds, a receivership is not to be used in hostile proceedings as a substitute for provisional liquidation or something of that kind."

In the instant case, the Full Court held that this was not a proper case for the appointment of a receiver. In arriving at this conclusion, it laid particular stress on the short notice of the proceedings that had been given to BBH, and also on the failure, in the *ex parte* proceedings, of NAB to offer, or the Court to require, an undertaking as to the payment of damages if the order were not sustained.

The High Court refused leave to appeal from this decision, primarily on the ground of the absence of an undertaking to pay damages.

In the light of this decision, we must ask again: Why security?

The writer does not resile from the proposition advanced above that the main reason for taking security over property is to avoid the *pari passu* distribution on insolvency, and in fact the case does strengthen the view that security is only one of several ways of obtaining this preferred status. One qualification has to be made, however: the advantage which security enjoys over subordination or negative pledges is that the secured creditor can still appoint a receiver out of court. The unsecured creditor is, at least in Victoria, virtually obliged to establish a case for a *Mareva* Receivership.