Introduction

(a) Working Group B

1. Parties which lend or supply goods or services on credit often take a security interest over property owned by the debtor in order to provide themselves with protection against the risk that the debtor will become insolvent before the debt is repaid. The effectiveness of that security interest against other secured creditors, or against third party buyers of the secured property, is determined by rules governing priority.

2. In 2002, the Law Commission considered the rules governing the priority of security and quasi-security interests. It concluded that the law is deficient for a number of reasons, and highlighted in particular that it lacks transparency and is unsuited to modern business practice. This was published as Consultation Report No 164.

3. In response, the Law Commission in 2004 proposed an extensive set of reforms designed to improve and clarify the law on priority of security and quasi-security interests. The reforms were published in Consultation Report No 176 (‘CR’) which contains a Draft Regulation (‘DR’).

4. The purpose of the Secured Transactions Law Reform Project (‘the Project’) is to consider possible reform to the law of secured transactions in England and Wales. Within the Project, a number of working groups have been set up to look at various aspects of the relevant law, and to reach conclusions on the desirability of reform and what form the reform should take. The specific remit of Working Group B (‘WGB’) is to consider what reforms might be useful to the law governing the priority of security and quasi-security interests. It takes as its starting point the reforms proposed in the DR.

(b) Case for reform of the priority rules

5. The work of the Project is informed by an understanding that English law is one of the world’s leading systems of both transactional law and the enforcement of contractual rights through the English courts. Further, the provision of security for the performance of obligations is a critical part of financial transactions.

6. The Project has produced a document setting out a detailed case for reform of the law of security in England and Wales (hereafter “Case for Reform”). The central argument presented is that the law falls short of meeting the legitimate expectations of the commercial and financial community in several key respects.
7. In relation to the law of priorities, the Case for Reform highlights *inter alia* that “the rules of priority as between competing secured creditors and other financiers are unnecessarily complex, partly because of the many different forms of security each of which has its own set of priority rules. The differences bear little relation to the practical situation and in respect of trade receivables can be almost unworkable in practice without incurring substantial expense. As a result the practical outcome is frequently uncertain. This often makes it necessary for the parties to enter into a priority agreement which would not be needed under a clearer system which emphasizes function over form.”

8. The Case for Reform concludes that “it is time to give detailed consideration to a radical overhaul of the law of security over personal property as a whole.”

9. This argument has been echoed by the City of London Law Society. In November 2012, the Financial Law Committee of the City of London Law Society produced a report entitled “Discussion Paper: Secured Transactions Law Reform” that considered the current state of the law concerning secured transactions in England and Wales (here referred to as ‘City of London Law Society Paper’).

10. The City of London Law Society Paper considered the law of priorities in detail at Part 5. It was concluded that there “is a consensus that the rules are too complicated and in need of reform... We see no alternative to a root and branch overhaul of the priority rules.”¹ In particular, the City of London Law Society Paper recommended that there should be a review of outright and secured transactions in relation to all types of asset, with a view to providing a coherent and simpler set of principles to determine priority.

11. Further, the work of the Project is supported by the conclusions reached by the Law Commission in the CR. The CR has concluded that the present English law governing the priority of security and quasi-security interests is deficient for a number of reasons. In particular, it is unsuited to modern business practice, productive of a lack of transparency and in many ways unclear and unsatisfactory.²

(c) Aims of the summary paper

12. The purpose of this paper is to set out and explain the conclusions that have been reached by the members of Working Group B (hereafter ‘WGB’) at this stage. It is intended to be a ‘living document’ and updated regularly as the work of the Group progresses.

¹ City of London Law Society Paper p22
² These reasons are set out more fully at CR 2.3 – 2.5.
13. The paper is divided into three sections –

i. **Section A**
   This section has two purposes. The first is to provide a brief overview of the current law of priorities in England and Wales. The second is to consider the changes proposed by the Law Commission CR and their justifications.

ii. **Section B**
   This section sets out the reasoned conclusions that WGB has reached on the priority of competing security interests and sales of receivables.
   Recommendations for reform are highlighted in bold text.

iii. **Section C**
   Section C deals with purchase-money security interests (‘PMSI’) and security interests in non-purchase-money proceeds and products.
SECTION A: OVERVIEW OF CURRENT LAW
& LAW COMMISSION PROPOSALS

(a) A critical summary of the existing law

14. The law of priority in England and Wales is detailed and complicated. Whilst a comprehensive summary of the current law is beyond the scope of this paper, this section attempts to briefly summarise the law and also to present, in as simple a form as possible, the problems that flow from it.

15. The following summary is derived in part from the Law Commission’s findings in the CR. A more detailed study of the points made here can be found in Part 3 of that report.

(1) There are four consensual security devices (mortgage, charge, pledge and contractual lien) and four quasi-security devices (conditional sale and hire-purchase and certain types of lease and consignment fulfilling a security function). Each of these forms of agreement has its own its own priority rules.

(2) The priority rules depend in some degree on whether the competing interests are legal or equitable.

(3) There are registration requirements for some types of mortgage and for all charges but not for other forms of security or for quasi-security agreements.

(4) The result of the narrow scope of the registration system is that no machinery exists for giving the public notice of non-registrable security interests or quasi-security interests that do not take effect in possession. This gives rise to a lack of transparency.

(5) Registration under the Companies Act is a perfection requirement. It is not a priority point. This requires some explanation.

Perfection is the legal term for the process by which a security is rendered effective against third parties. There are currently three ways in which perfection can take place. These are:

i. registration,
ii. by the secured party taking actual possession of the collateral, or
iii. where the goods are in the possession of a bailee, by the bailee attorning to the secured party or issuing a document of title in the secured party’s name so as to take constructive possession of the collateral.
In addition, perfection of security interests over limited types of property such as investment securities and bank accounts may occur by the secured party taking ‘delivery’ or obtaining ‘control’. This is an alternative form of constructive possession.

In each case, the method of perfection is designed to give notice of the existence of the security interest. However, the issue of the effect of perfection is separate from the issue of whether the buyer of an asset takes free or subject to security.

Note that in order to be perfected, the secured party must already have acquired a proprietary right in the relevant collateral (known as the secured interest ‘attaching’ to the collateral). The process of attachment renders the security interest enforceable against the debtor only. The attachment and the steps taken to perfect the security interest can occur in any order, but perfection will not occur until both have been completed.

The consequence of registration operating as a perfection point but not as a priority point is that the registration renders the security enforceable against the liquidator, administrator or creditors of the company but does not necessarily determine the relative priority between competing creditors.

Two disadvantages flow from this distinction between registration and priority.

The first is that a person who is first to register may find himself postponed to a prior secured creditor who has not yet registered: a creditor who makes a search, finds nothing on the register and registers his security interest may find that his security ranks behind an earlier creditor who still has time to register.

The second disadvantage is that it is necessary to lay down a period (21 days) for registration and to require leave to register out of time. This involves delay and expense.

(6) The priority of competing assignments is governed by the common law rule in Dearle v Hall. This rule states that the priority of the assignments depends on the order in which notice of assignment is given to the debtor.

This rule presupposes that an intending assignee will make enquiry of the debtor to see if it has received a prior notice of assignment. Such a procedure is wholly impracticable for bulk continuing assignments such as factoring.

Nonetheless, the City of London Law Society Paper notes that the rule that both priority and discharge of assignments depends on notice has “a certain practical appeal.”
The existing system is one of transaction filing, as opposed to notice filing. Under this existing system, a certificate of registration is issued by Companies House only when the original instrument of charge and supporting documentation have been submitted.

This has the disadvantages that the registration relates only to a single transaction, and that it can occur only after the transaction has been entered into. A transaction filing system does not allow for the filing of an intended security interest, which would operate to protect the position of the creditor during negotiations (this is known as ‘advance filing’).

The floating charge has proved a valuable security device. However, it continues to attract litigation both as to characterisation and as to its effects. Moreover, there remains doubt as to the impact of crystallisation on subsequent security interests taken with notice of the floating charge but not of its crystallisation.

Sales of receivables are not registrable. They are thus not visible to the public. Further, their priorities are governed by the rule in Dearle v Hall. For the reasons explained at point (5) above, this rule is impracticable in the case of bulk receivables financing.

(b) Scheme proposed by the Law Commission

16. In place of the existing law, the CR sets out a proposed reform to the law of priorities in England and Wales. The outline of this reform is presented below. A full copy of the proposed DR is set out as Appendix A to the CR.

17. A single concept known as the (fixed) security interest would replace the various forms of security interest referred to above. The distinction between legal and equitable security interests would cease to be relevant to priority between competing consensual security interests. Instead, priority rules would instead be based on the function of the interests and on producing outcomes that are commercially reasonable.

18. The CR proposes that a system of notice filing should be introduced. All security and quasi-security interests under which the creditor does not have possession or control would be registrable through a simplified, electronic notice filing system. The ‘financing statement’ registered would include details of the parties, brief details of the collateral, and the duration of the filing (which could be a fixed time or unlimited). The register will be a ‘real-time’ system that is able to be searched as soon as the registration process is completed.

19. The CR contemplates that it would be possible to file in advance of the creation of a security interest in order to allow the creditor to protect his position during negotiations.
20. The CR proposes a system of general (or ‘residual’) priority rules. These would apply to determine the priority between competing security interests in the absence of a more specific priority provision. They are as follows:

(1) A perfected security interest has priority over an unperfected security interest

(2) The priority of competing perfected security interests both of which are perfected by filing is determined by the order of filing

(3) The priority of competing perfected security interests of which one is perfected by filing and the other in a different manner, e.g. by possession or control, is governed by the order of perfection.

(4) As between unperfected security interests, priority is determined by the order of attachment, but this may be displaced if the later interest is subsequently perfected first

(5) Priority between competing security interests under the above rules may be varied:

(a) by the inclusion in a security agreement of permission to the debtor to grant a security interest to another creditor ranking in priority to the first creditor’s security interest or

(b) by agreement between two secured parties;

(6) The priority of a security interest under the above rules applies to all advances, including future advances, whether or not made under an obligation and whether or not made with notice of the subsequent charge.

(7) A transferee of a security interest has the same priority as his transferor
(a) Effect of perfection on priority

**Recommendation 1**

WGB recommends adopting the general rule that a perfected security interest should have priority over an unperfected security interest.

21. This general rule states that a perfected security interest will have priority over an unperfected security interest. This recommendation is not considered to be controversial.

(b) Priority of two competing interests perfected by filing

**Recommendation 2**

WGB recommends adopting the general rule that priority of competing interests where both are perfected by filing will be decided in order of filing.

. Filing is recommended by WGA as the principal method of perfection that should be adopted and this recommendation assumes that a filing system will be adopted.

22. This general rule would apply in a scenario where two creditors hold security interests in a given asset, both of which are perfected by filing. The result would be that priority will follow the order of filing: the creditor that was first to file notice of his interest will take priority in the collateral.

23. This represents a fundamental change to the current law. The effect of this recommendation would be to dramatically simplify the current law of priorities. It would enable parties to determine the relative priority of secured interests by looking at the register.

24. As explained above, at present registration or filing is merely a perfection requirement and does not determine priorities. Provided that a security interest is registered within 21 days, it has priority according to the date of its creation. A security interest created first in time but not yet registered will therefore have priority over a security interest that is created later in time but is registered, provided that the 21 day period allowed for registration of the first security interest has not expired.
25. In practice this generates risks for creditors on the basis that collateral may be bound by a prior security interest that has been created in the previous 21 days but not yet registered. This risk is naturally associated with costs and increased due diligence requirements.

26. The recommended change would provide that where the competing security interests are both perfected by filing, priority would follow the order of filing rather than order of creation. This solution would lead to associated costs and potential risks for secured creditors being reduced or eliminated.

(c) Advance filing

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<td>WGB further recommends that advance filing should be possible, subject to conditions of debtor consent, mechanisms for allowing a debtor to clear its register and time limitations.</td>
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27. This recommendation and the discussion on advance filing that follows is provisional and subject to further consideration. In particular further work is required to consider the ways in which registrations would lapse in order to prevent the register from clogging up. A comparison with other jurisdictions and the operation under the Bills of Sale Acts will be carried out.

28. It was briefly noted above that the CR contemplates the possibility of filing in advance of the creation of a security agreement.

29. Advance filing allows a potential secured party to file while negotiations are proceeding. This allows them to protect their position vis-à-vis other creditors. Advance filing could be useful in particular in closings of complex transactions. It has the further advantage of enabling a secured party to file just once for a series of future transactions with the same debtor.

30. The CR contemplates that the general rule would apply to advance filing. As a result, the first creditor to file notice of their proposed security interest would take priority over those yet to file. This would be the case regardless of whether the proposed security interest is in fact created, subsequent to the filing.

31. A simple example is useful to indicate how the advance filing fixes priorities:
Person A files a financing statement/notice of the proposed interest on Day 1. Person B files their security interest on Day 2. On Day 3, Person A's transaction completes and their security interest is created.

In those circumstances, Person A will have priority where the filing of a financing statement determines the date of filing of the completed security interest.

32. WGB have considered the risk that advance filing will clutter the register with notices that do not represent created security interests, for example in cases where negotiations could not be completed and a transaction is not implemented or security is not created.

33. To manage this risk, three controls on advance filing are recommended:

i. Debtor consent

Filing will only be effective if done with the debtor’s consent. WGB expect that a debtor would be cautious in giving their consent to a filing. This applies particularly to advance filing.

ii. Mechanisms for register clearing

The debtor will have a right to removal of ‘empty’ filings from the register. Further, if further finance is sought from another creditor who is to be secured then WGB expect that the further prospective secured creditor will insist that filings in respect of the collateral that are not concerned with existing securities are removed. The CR notes that the effect of these mechanisms in practise is that the register becomes ‘self-cleansing’ to a degree.\(^3\)

iii. Time limitations

WGB recommends placing a time limit on advance filing. The duration of the time limit is yet to be considered.

34. Further, WGB note the findings of the CR that enquiries in other jurisdictions that operate an advance filing system suggest that cluttering of the register has not proved a problem and that accordingly the risk is considered to be small.

\(^3\) CR 2.54
(d) Priority of two competing interests where only one perfected by filing

Recommendation 4

WGB recommends that between two competing interests where only one is perfected by filing, and the other was capable of being perfected by a different method and is perfected by that method and not by filing, the priority depends on which interest was perfected first.

35. This recommendation and the discussion that follows should be read in conjunction with WGA’s paper that considers methods of perfection.

36. This general rule applies to determine the priority between two competing interests, one of which is perfected by filing and another is perfected by an alternative method such as taking possession of the collateral. The rule here is that priority depends on which came first, the filing or the perfection otherwise than by filing.

37. This recommendation follows logically from the recommendation 2 above that priority of competing interests both of which can be perfected by filing will be decided in order of filing. The effect of recommendation 4 is that security interests which are perfected by methods other than filing should not be placed in a more advantageous position vis-à-vis security interests which are perfected by filing.

38. WGB notes that the effect of this rule is that priorities can change. The following example is useful:

A files a financing statement on Day 1. On Day 2, B takes possession of relevant assets. At that point B has priority, being the only person with a security interest. On Day 3, Person A completes the transaction and its security interest is created.

In those circumstances, though A’s interest was created later it will have priority because its financing statement was filed prior to the taking of possession by B.

39. WGB accept this as a sound result, on the basis that as a result of the filed statement B will have been put on notice that its security interest was liable to become subordinated upon the attachment of A’s security interest.
(e) **Priority between two unperfected security interests**

**Recommendation 5**  
*subject to further consideration*

WGB recommends that as between two unperfected security interests, priority in the first instance will be determined by order of creation.

40. This rule is consistent with the current rule where unregistered charges sit at the end of the priority queue and as between themselves rank in order of creation.

41. WGB note that the relevant date for determining priority between unperfected interests should be the date of creation and not the date of attachment. In the WGB discussion papers derived from the CR, the term “attachment” referred to a point in time where the parties agreed to create security immediately and where the debtor had powers to dispose of the asset. Attachment would take place later in time than creation in relation to future assets. When two creditors take security in the same after-acquired property on different dates, they could rank *pari passu* if the attachment were a priority point but not if the date of creation were a priority point. This suggests the date of creation would be a more suitable date for determining priority between unperfected interests.

(f) **Priority rules as to future advances**

**Recommendation 6**

WGB recommends that priority under the rules above applies to all advances, including further advances, whether or not made with notice of a subsequent charge.

42. This rule applies in a scenario where a Person A, having already filed notice of his security interest, extends a further advance to the debtor. A question of priority arises if Person B registers a charge in the period after Person A has filed notice of their charge but before the making of their further advance.

43. The recommended rule is that the priority rules apply to all advances, including further advances, whether or not made with notice of the subsequent charge. The application of this rule to the scenario above means that the notice filed by Person A grants him priority over Person B.
44. The justification for the proposed rule is that all potential creditors can review the register and approach existing creditors as necessary to determine what prior secured interests exist. The change is consistent with the increased importance of the register in the recommended changes to the general priority rules.

45. WGB noted that difficulties could arise on transaction closing. In the scenario where loan monies have already been advanced prior to the completion of the registration process and a third party creditor advances money and files security documents in the interim, any difficulties of priority are resolvable using the advance filing rule recommended above.

(g) Prior notice of an unperfected interest

DRAFT Recommendation 7 *subject to further consideration

WGB recommends that the buyer or other disponent takes the collateral free of an unperfected security interest in collateral unless he has actual knowledge that the sale or other disposition violates the terms of a security interest.

46. This rule reflects the position that the creditor can perfect at any point (up to the moment of a debtor’s insolvency or bankruptcy). Therefore, if the creditor does not perfect, he should bear the risk of lack of protection.

47. WGB agreed that this rule should not apply in cases where the buyer had actual knowledge that the transfer or other disposition of an asset was in breach of the terms of a security interest. Such knowledge could arise as a result of collusion between the debtor and the third party. The creditor, whose interest is unperfected, should not bear the consequences of such a transaction between the debtor and the third party. Thus, the creditor’s unperfected interest should not cease to encumber the asset when disposed of to a third party who had actual knowledge that the disposition breached the terms of the security interest between the creditor and the debtor.

48. A similar rule has been adopted in the UNCITRAL Legislative Guide on Secured Transactions, where it has been recognised that if the buyer has actual knowledge that the transaction violates the rights of secured creditors under the terms of the security agreement, the buyer does not take free of unperfected security interest.

49. An alternative solution would be to introduce a fraud exception, so that the creditor with an unperfected security interest would not lose its security where the third party acted fraudulently. However, WGB noted that a fraud exception posed the problem of defining the perimeter of fraud accurately and the risk that the courts would be tempted to
expand the definition of fraud in ways that are unpredictable and that might undermine commercial certainty. WGB further agreed that a buyer should not generally be required to check the register.

50. WGB also agreed that the exception should not extend to constructive knowledge given the existing negative attitude by courts to constructive knowledge in English commercial law.

(h) Priority variation agreements

**Recommendation 8**

WGB recommends that priority can be varied by the creation of priority agreements between creditors, provided that such agreements do not prejudice the position(s) of intermediate creditors and without any requirement for debtor consent.

51. It is uncontroversial that priority rules can be varied by agreement between creditors. The current law does not preclude competing creditors from entering into an agreement to vary the priority rules that would otherwise apply between them *inter se*. Statutory provision has in many cases made express provision for such variation.⁴

52. WGB agreed that it should be possible for creditors to agree to subordinate their priority position, provided that it does not result in any intermediate creditor being disadvantaged. It should be clarified that debtor permission is not required and that such subordination is made without prejudice to the position of intermediate creditors.

(i) Priority agreements

**Recommendation 9**

WGB recommends that priority agreements should be filed and, if not filed, the subordination agreed thereunder will not be valid against a transferee of the subordinated security interest.

53. A common form of variation is agreement between two secured creditors that one will subordinate their security interest to the other. This has the result that the grantor of the agreement is subordinated to the beneficiary of the agreement and any creditors who

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rank in priority to the beneficiary. To take the example from *Re Portbase* [1993] Ch 388, an agreement by a fixed chargee to subordinate his interest to that of a floating chargee will mean that the fixed chargee is subordinate to both the floating chargee and the preferential creditors, since the preferential creditors rank in priority to the floating chargee.

54. WGB considered in what circumstances an assignee of the subordinated debt would be bound by the subordination agreement. WGB recommend that subordination agreements must be filed by the beneficiary of the subordination agreement. The result of a failure to file is that the subordination agreement would not take effect against a subsequent assignee of the subordinated interest: the beneficiary of the agreement would in effect lost out to the assignee. This would be the result regardless of any actual notice by the assignee.

55. The reason for this recommendation is to prevent a situation where a buyer of senior subordinated debt has no means of finding out that such senior debt is subordinated. This knowledge is fundamental from the assignee’s perspective. A requirement to file would allow the assignee to protect his position by undertaking a search of the register prior to taking assignment of the security interest.

56. WGB considered whether the effects of failing to file should be mitigated in the scenario where the assignee has actual knowledge of the subordination agreement. It was concluded that this was a less robust alternative than the proposed rule. The proposed rule also removes the possibility of entering into disputes as to states of knowledge and is consistent with the rule above about purchasers of assets subject to unregistered (but known about) charges.

57. WGB found that a functionally identical provision to the proposed rule is found in Article 29(5) of the 2001 Convention on International Interests in Mobile Equipment (‘the Cape Town Convention’) and functions well.

Question for consideration: if the subordination agreement has not been filed, should the holder of the priority security interest be able to maintain the priority if it assigns the security interest?

(j) Sales of receivables

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<td><em>SUBJECT TO FURTHER CONSIDERATION</em></td>
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<td>[WGB recommends that sales of receivables should be brought within the registration provisions and priority rules applicable to security interests.]</td>
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58. Sales of receivables are a common form of finance that is used by traders who wish to convert receivables into cash. Where a sale is made with recourse to the seller/trader then the assignee of the receivables requires the trader to guarantee the purchaser against
default by the debtors. A sale of recourse is thereby difficult to distinguish from a charge on the receivables as security for a loan: in each case the trader receives cash and must later account to the assignee for the value of the receivables assigned.

59. The CR did not deal in detail with the sale of receivables. The issue was however given detailed attention in Part 4 of the CSI, which recommended that sales of receivables be brought within the registration provisions and priority rules applicable to security interests. The CSI also provided a definition of receivable for the purpose of the proposed changes.

60. The CR reports that it is at present hard to find out whether a company has sold, rather than charged, its receivables.\(^5\)

a. **Definition of receivables**

61. For the purpose of registration and priority WGB adopts the definition of the term “receivables” as:

   “Monetary obligations, whether or not earned by performance, arising from –

   (a) the supply of goods or services (other than insurance services),
   (b) the supply of energy, or
   (c) brokerage services,

and “sale”, in relation to receivables, includes an agreement to sell (DR 2(3) in CIS).

62. The above proposal received much support from the asset-based finance industry, particularly from what is now the Asset-Based Finance Association, but significant concerns remain from certain parts of the legal profession.

b. **Applicable priority rules**

63. It is possible for two competing interests to arise where the assignor has made a double assignment of the receivables. For example, the assignor might sell the receivables to Person A and then subsequently grant Person B a security interest in the same receivables.

64. Under the present law the priorities are determined by the rule in *Dearle v Hall* which states that the first assignee to give notice of the assignment to the debtors will take priority. Using our previous example, priority under *Dearle v Hall* would turn on whether Person A or Person B was first in time to notify the debtors who owe money to the assignor under the receivables.

\(^5\) CR 2.87
65. WGB further recommend that the rule in *Dearle v Hall* should be replaced by the general registration and priority rules above. [The difficulty in distinguishing between a secured interest over receivables and outright sale of receivables justifies bringing all outright sales of receivables into the general scheme. In addition, it is not practicable for assignees of receivables to notify debtors where non-notification receivables financing is common: the rule in *Dearle v Hall* is no longer fit for purpose.]

66. [Instead, a registered sale would have priority over an unregistered security interest or sale, and priority between registered security interests in receivables and registered sales of receivables, or between competing registered sales of receivables, would be governed by the order of filing of the financing statements. Notice to the debtor would only be necessary in order to collect the debt directly from the debtor.]

67. [Note, however, that registration of receivables should be a priority point only. Separate perfection requirements may apply.]

68. Further consideration must be given to the relative positions of receivables financiers and inventory financiers.
SECTION C: PURCHASE MONEY SECURITY INTERESTS (PMSIs)

(a) An introduction to purchase money security interests

69. A purchase-money security interest (PMSI) is an interest that arises in two scenarios. The first is where a seller takes an interest to the extent that it secures payment of the purchase price of collateral. This would include the seller's interest under retention of title arrangement under the current law. The second is where a lender takes an interest to the extent that it secures an advance made to enable the debtor to acquire rights in collateral and the advance is in fact so used and the security agreement is made prior to the acquisition of rights in the collateral.

70. A priority issue that arises is whether a PMSI in collateral or its proceeds should have priority over a previously perfected security interest covering the debtor’s after-acquired property. An example of this could work as follows:

Person A enters into an agreement that grants Person B a security interest over property that is subsequently acquired by Person A. That security interest is perfected. Subsequently, Person A enters into an agreement that grants Person C an interest in collateral that is acquired using an advance provided by Person C.

71. English law does not possess a distinctive priority rule to resolve this conflict. Instead, it finds that an after-acquired property clause can only catch future property in the form in which it is acquired by the debtor. If such future property is encumbered with a security interest in favour of the second financier or, in the case of title reservation, does not belong to the debtor at all, the previously created and perfected security interest is subject to it or there is no property which can be subject to the previously created and perfected security interest, as the case may be. The practical result of this reasoning is that the holder of the PMSI has priority.

(b) Definition of a PSMI

Recommendation 11

WGB recommends that a purchase money security interest shall not include interests that arise following an initial advance made on an unsecured basis.

a. Advanced interests

72. WGB notes that the definition of “purchase money security interest” in the DR did not explicitly carve out unsecured advances. Therefore, on a literal construction of the definition there is a risk that a security interest could be classified as a PMSI even where
the original advance was made on an unsecured basis. WGB notes that the same
definition issue arises under Article 9 of the United States Uniform Commercial Code.

73. WGB recommend that the definition should be subject to a carve out for unsecured
advances. To include such interests within the definition would run contrary to the
concept of a PMSI in English law whereby a lender receives an interest in collateral only
to the extent that it was agreed that the lender would receive an interest in it.

(c) Inventory and its proceeds: conditions of priority

[Uncertain how to formulate the general rule.]

74. WGB notes the importance for inventory financiers to know if there are PMSIs in
inventory held by company prior to making further advances. This is particularly so
because the inventory financier will be subordinated to the holder of the PMSI.

75. It is therefore proposed that the priority of the PMSI financier is made subject to a
number of conditions.

76. The first of these is that the security interest is created before the point in time at
which the debtor acquires an interest in or takes possession of the asset (that is to say,
before the collateral is purchased).

77. The second is that notice has been given to the earlier financier who has filed a
financing statement that would cover the relevant asset. There is no grace period as
PMSIs are most likely to arise as part of a long-term relationship.

78. Should the recommendation of advance filing be implemented, one filing will cover
all future transactions.

79. WGB note that the inventory financier would still be able to exclude the portion of
the inventory subject to a PMSI for the purpose of determining whether or not to make
further advances, as it would receive notice of the PMSI.

80. The position with respect to inventory and proceeds where a company has both
receivables financing and inventory financing is complex and this will be discussed
separately.

[Recommendation 11 – To be discussed further]