Retention of Title Devices: Registration with or without recharacterisation

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Abstract: Asset financing involving conditional sale, lease, or hire purchase agreements are functionally similar to secured transactions. One issue in the debate led by the Secured Transactions Law Reform Project is whether a new, best-in-class, regime should include title-based financing and, if so, to what extent. Many jurisdictions opted for recharacterisation of title-based financing as secured transaction. Whether this is the best way forward cannot be considered without debating other options, one of which is registration without recharacterisation. This paper introduces the key considerations I have set out in more detail in the Project discussion paper: "Asset Finance", at https://securedtransactionslawreformproject.org.

Key points

- **We need best-in-class law of secured transactions and asset finance**
- **Conditional sale, hire purchase and lease agreements in some other jurisdictions are recharacterised as security interests but some consider this problematic**
- **Registration without recharacterisation is a new option not considered before**
- **A fresh debate to help lead the way forward: your views welcome!**

Introduction

Conditional sale, hire purchase and lease agreements (referred to collectively as "title-based financing transactions" or "asset finance devices") are asset finance techniques, frequently used in financing acquisition of new assets such as vehicles or equipment by businesses or individuals. They are typically concluded either directly with suppliers of assets or with finance houses to whom those assets are first sold by the suppliers. They can also be used to raise finance against existing assets by selling those assets to a finance house and, for example, leasing them back.

One of the key issues in the debate on the reform of the secured transactions led by the Secured Transactions Law Reform Project (Project) has been whether, and to what extent, a new regime should include title-based finance transactions and to what extent. There are three main possibilities. One is to leave them outside the reform. Another is to introduce registration and recharacterisation of asset finance devices as security interests, meaning that the rules governing priority and remedies would be the same as those governing security interests (the so-called functional approach). The third option, not considered in detail before, involves registration without recharacterisation, so that the financier would be treated as an owner of the asset.

The third option has sparked some initial interest and consultation with stakeholders on whether this is the best way forward is ongoing. Before turning to the key aspects of the debates on asset finance devices, it is convenient to outline their basic forms.

Conditional sale, hire purchase and lease: basic concepts

Conditional sale agreements are contracts for sale of goods containing a clause that title does not pass to the buyer until a stipulated condition has been fulfilled, typically until the price has been paid in full. The finance-taker is bound to buy the asset. Contracts for sale of goods with retention of title clauses are also used in inventory financing, but they raise separate issues, and are not discussed here.

By contrast to a conditional sale, a hire purchase agreement carries merely an option to purchase. The most obvious consequence of this is that a buyer under a conditional sale agreement can pass good title under s 25(1) of the Sale of Goods Act 1979 while a hirer or a lessee cannot. A hirer may, however, pass good title under Part III of the Hire Purchase Act 1964.

Various form of conditional sale and hire purchase are used in vehicle financing. For example, it is common that the finance-taker agrees to pay a deposit at the start, reduced rentals throughout and a larger sum at the end. Where that sum is optional, this is referred to as the 'personal contract purchase', a form of hire purchase. Where the finance-taker is obliged to pay (and to buy), the agreement is known as a 'lease purchase' and is a form of conditional sale agreement, often used to finance, e.g., premium cars.

Lease agreements, in turn, involve neither an obligation nor option to buy. They are often used in the financing of business equipment, for example gym equipment, plant machinery or office laptops. Where rentals are spread over the economic life of the asset, there is no expectation to return the asset to the lessor at the end of the term of the lease. Such leases are known as finance leases by contrast to operating leases which are for a period shorter than the economic life of the asset, a distinction which may become less prevalent once the standard accounting practice of leases changes.

What conditional sale, hire purchase and lease agreements have in common is that the finance house (or the supplier) retains title to the asset while the finance-taker obtains possession and is obliged to make payments over an agreed period, generally intended to amount to the price of the asset, plus interest on capital.

Functional approach: registration and recharacterisation

The economic purpose of title-based financing transactions is similar to that of a mortgage or a charge: to facilitate raising finance while reducing the risk of non-payment, particularly on insolvency, by means of a proprietary interest. This similarity has led to adoption of a functional approach in Article 9 of the Uniform Commercial Code and under Personal Property Security Acts in, e.g., Canada, New Zealand and Australia.

Under the functional approach, title-based finance transactions are treated (recharacterised) as secured transactions. This means that: (i) the extent of the finance taker's (debtor's) interest (equity of redemption) in the encumbered asset is based on the extent of repayment of the secured debt; (ii) the financier has a duty to account to the

debtor for any surplus over and above the outstanding amount of the debt; (iii) to the extent that there remains any outstanding debt after the financier enforced its interest in the asset, the debtor remains liable to pay; (iv) title-based financing transactions are registrable in the same public register, and generally with the same effect, as security interests.

One of the strengths of the secured transactions law in this “functionalist” guise is the increased publicity and transparency of non-possessory interests as part of a wholesale reform of the area. From the perspective of third parties, a more comprehensive, easy-to-access register reduces costs of due diligence. Registration also plays some role in averting the risk of fraud. Another advantage of the functional approach is that it facilitates simplification of priority and enforcement rules applicable to what previously were various secured and title-based financing transactions.

The downside of the functional approach is that unregistered asset finance devices lose priority to other security interests and are generally void on insolvency, which means that the financier loses its reversion on the insolvency of the finance-taker. This is a harsh consequence, perceived as amounting to expropriation. Some jurisdictions relaxed this rule. For example, in New Zealand unregistered asset finance devices are not void on insolvency. Other arguments against the functional approach are that it imposes on the parties a different bargain to the one they intended to enter into, contradicting the party autonomy principle.

Registration without recharacterisation?

The issue of desirability of registration of asset finance devices is separate from desirability of recharacterisation although the way in which these devices would be registered would be undoubtedly driven by the answer to the prior question about their recharacterisation.

That registration of title-retention financing is seen as useful in England can be gauged from the fact that commercial organizations such as HPI or Experian already manage registers of finance agreements of vehicles and other equipment. Yet, under English law, the existing commercial registers are limited in their function and reliability since there are no sanctions for non-registration (see *Moorgate Mercantile Co Ltd v Twitchings* [1977] AC 890 (HL)). Asset finance would become more transparent if online registration of asset finance devices were introduced, for example by ensuring that one filing would suffice to place information on both the debtor register and any designated asset register (for discussion of registration, see Project discussion paper authored by Professor Louise Gullifer, “Registration”, at https://securedtransactionslawreformproject.org). There is also scope for the future registers to use more recent technological advances.

Where the asset finance device is recharacterised as a security interest, the debtor has a proprietary right to surplus proceeds, and so the debtor can create security interests in what could be called equity of redemption. It is possible to envisage a system where asset finance interest would be registrable with a default rule that the asset financier has the right to surplus. The rule being default, surplus could be contractually made over to the debtor.

One question is to what extent the debtor's dealing with that right to surplus could resemble dealings with equity of redemption. Another question relates to limits on that right. Since the right to surplus would be based in contract, and there would be nothing *prima facie* to compel the financier to agree that debtor should obtain the surplus, it would be relatively easy for the financier to extend the asset finance device to, for example, cover wider liabilities. It would, therefore, be relatively easy to "clog" the right to surplus, unlike equity of redemption. This is not of itself good or bad, but rather an invitation for views on how the interests should be balanced.

Making asset finance devices registrable in a public register without recharacterisation necessitates discussion on creation of new exceptions to *nemo dat*. For example, granting the finance-taker powers of disposition of the asset free of an unregistered (and unrecharacterised) asset finance device could operate as a new exception to *nemo dat* rule, probably going so far as to substitute Part III of the Hire Purchase Act 1964 and to some extent also s 25(1) of the Sale of Goods Act 1979. The need for review of the relevant priority and property law rules is not a bad thing. There are areas in which the balance of interests between the owner and the third party disponor or other third parties such as the holder of a charge over land to which the supplied asset has been affixed, could be better struck.

Conclusion

The idea of registration of asset finance devices without recharacterisation is not a conceptual impossibility, as might have initially been thought. It deserves a debate. Anyone with interest in this area, or the law of secured transactions, is welcome to engage with the Project: https://securedtransactionslawreformproject.org. Comments directly to the author also welcome.