LEGAL UPDATE NEWSLETTER

Schweizer Kobras
LAWYERS & NOTARIES

Retention of Title Clauses: Treatment by Australian Courts - Part 1

It is common practice to sell goods subject to a retention of title clause. Generally, the effect of such a clause is that title to, or ownership of, the goods is retained by the seller until the goods are fully paid for, even if the goods have already been delivered to the buyer. Such clauses are only used when the seller is seeking to recover the goods or the proceeds of sale or use of the goods from the liquidator of an insolvent company. In this first of a two part series, the treatment of such clauses by Australian courts is discussed.

Traditionally, the courts have found that retention of title clauses constitute a charge on either the goods or the proceeds of resale of the goods as security for the payment of the debt to the seller. However, because the charge is not registered as required by the Corporation Act 2001 Cth (the Act), the charge cannot be enforced and is thus void against a liquidator under Section 266(1) of the Act.

In Radio Frequency Systems Pty Ltd v Guthrie (2000), the seller supplied goods under a retention of title clause to a company which, at the time the liquidator was appointed, was in possession of the goods. At first instance, the Court followed the traditional approach that the retention of title clause constituted a charge and, because it was unregistered, it was void against the liquidator. On appeal, the seller argued that the retention of title clause did not create a charge but, instead, effected a re-transfer of the title to the goods back to the seller. In other words, the seller argued that the clause meant that if the goods had not been resold or altered, the seller continued to own the goods (rather than that the company buyer had acquired title to the goods and given security to the seller in the form of a charge). The Supreme Court of Western Australia agreed with the seller and held that the seller retained title to the goods until they were paid for.

Significantly, the Court in Radio Frequency Systems also held that backdated retention of title clauses have the effect of re-transferring title in goods already given to the buyer back to the seller, even though the contract was created, and delivery of the goods had already occurred by the time the parties agreed to the retention of title clause. As a result, payments made by the seller for the goods would be protected against the liquidator under the backdated clause. It should be noted, however, that if the company had been insolvent at the time that the sale was made, the liquidator would have been able to reverse the effects of such a backdated retention of title clause as an insolvent uncommercial transaction under section 588FB of the Act.

In an alternative situation, a seller may not be seeking to recover the goods sold to a buyer company or the liquidator but, rather, may be seeking to recover the proceeds of the sale of the goods by the company. In Downey v Aira Pty Ltd (1996), the contract provided that title to the goods was retained until the goods were fully paid for and that the proceeds of any resale by the buyer were to be held on trust for the seller. The Court held that, in this case, the retention of title clause gave the seller security over the proceeds of resale by the company, which were a book debt, and therefore the clause constituted a charge over those debts. However, because the charge was not registered, the clause could not be effective against the liquidator. As a result, the liquidator was held to be able to retain the proceeds of sale of the goods as part of the assets of the company for general distribution to creditors.

The position in Downey v Aira is somewhat difficult to accept, especially given that the wording of the clause expressly created a charge over the proceeds of resale of the goods rather than establish some form of security. This issue was revisited in Associated Alloys Pty Ltd v ACN 001 452 106 Pty Ltd (2000) in which the majority of the High Court of Australia decided that such a clause did not constitute a charge but was, instead, a trust over the proceeds of sale of the goods and, as such, was not part of the assets of the buyer company subject to the control of the liquidator.

In Associated Alloys, the Court also held that if the seller could show the necessary connection between the funds received by the buyer and the goods supplied by the seller under a particular invoice, the seller would be entitled to recover and keep the funds. These cases appear to give effect to the true commercial intent of retention of title clauses in giving security and protection to suppliers. By avoiding characterising the retention of title clauses as a charge, which would be void against a liquidator, the courts have allowed the clauses to have the intended result of retaining the seller’s title in the goods or to secure the payment for the seller.

However, it is important for retention of title clauses to be well drafted and in fact incorporated into the contract under which the goods are sold. Given that such clauses have the effect of partly defeating the policy objective of the Act in maximising the return to creditors from the assets of insolvent companies, the wording of these clauses and the effectiveness of their incorporation into any contractual relationships will

be intensively scrutinised by the courts. To that end, it is important that retention of title clauses:

- operate both prospectively and retrospectively;
- expressly state that the seller retains title to the goods;
- expressly provide that the proceeds of sale of the goods are held on trust for the seller; and
- expressly provide that, if the goods have been used or incorporated into other goods, then the proceeds of sale of those other goods are also held on trust for the seller.

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Recent Cases involving Letters of Credit: Lessons for Importers

Recently two Australian cases have created some uncertainty about whether the traditional approaches of Australian courts towards letters of credit will continue to apply. In particular, the cases may have narrowed the scope of the rule concerning strict compliance and autonomy of letters of credit, and pose some noteworthy risks for importers.

Generally, there is little protection for importers who use a letter of credit as a means of payment because a foreign exporter will receive payment before the goods are received and examined by the importer. The main protection for importers lies in the imposition of particular terms in the letter of credit itself and confidence that banks will require the exporter to strictly comply with them. Until the recent cases, the terms in a letter of credit were to be construed as “autonomous”, that is, not to be interpreted using extraneous documents and, by the principle of strict compliance, banks were required to ensure that the terms had been exactly complied with before payment.

Ideas Plus Investments Ltd v National Australia Bank Ltd

In Ideas Plus Investments Ltd v National Australia Bank Ltd (2005), the principles of autonomy and strict compliance were under challenge. In this case, a borrower gave a mortgage debenture and an irrevocable letter of credit as security to the Australian lender. After the borrower defaulted and failed to pay despite multiple notices of demand, the lender successfully asked the bank to honour the letter of credit without first seeking to realise the assets that were subject to the charge, even though this appeared to have been one of the conditions for payment under the letter of credit.

The Court held that the condition was inconsistent with the “commercial object” of a letter of credit. The Court suggested that the commercial utility of a letter of credit is as a readily realisable security, which would be defeated if the lender was required to take the time to appoint a receiver and have the receiver realise the assets concerned by the security before calling on the bank to pay under the letter of credit. Further, the Court suggested that the court must determine the intention of the parties in construing the terms of a letter of credit.

Boral Formwork & Scaffolding Pty Ltd v Action Makers Ltd

The autonomy principle was further attacked in Boral Formwork & Scaffolding Pty Ltd v Action Makers Ltd. However, in this case, the pendulum swung in favour of the importer. In its case, Action Makers Ltd (the “applicant”) gave a letter of credit for $2.3 million as security for its performance under a contract to provide scaffolding to Boral Formwork & Scaffolding Pty Ltd (the “beneficiary”). When there was a dispute between the parties, the beneficiary sought to draw on the letter of credit from the bank.

The Court held that while the beneficiary had complied with the terms of the letter of credit, the applicant was entitled to prevent the bank from paying out under the letter of credit. This was because the beneficiary, by seeking to draw on the credit, was acting unconscionably in contravention of sections 51AA and 51AC of the Trade Practices Act 1974 (Cth).

Lessons for Importers

These cases have cast some doubt on the protection traditionally given to importers through the principles of autonomy and strict compliance which usually apply to letters of credit. However, despite these misgivings, the letter of credit remains the preferred means of prior payment because it affords much greater protection to the importer over almost all other forms of payment (except, of course, where the importer is allowed to pay after receiving and examining the goods). Therefore, the importer needs to exercise caution if the letter of credit imposes conditions that are burdensome or ambiguous.

This overview is based on an article by Ricky J. Lee that was published recently in the Macquarie Journal of Business Law. Please contact us if you would like a copy of the article.

New Senior Associate

Ricky J. Lee has recently joined the firm as a Senior Associate, bringing with him over a decade's experience in corporate and commercial law, international business law, commercial litigation and technology law.

Ricky has a Bachelor of Arts (International Studies) and a Bachelor of Laws from the University of Adelaide and a Master of Laws (International Law) from the Australian National University. He is currently completing a doctorate of law in international law from Murdoch University, a Master of Taxation from the University of New South Wales and a second doctorate in international law from the University of Cologne, Germany.

Ricky has a number of years of experience involving a wide range of commercial law, particularly in relation to aerospace, corporate, government, health, insolvency, international trade, litigation and trade practices law. Prior to joining the firm, Ricky worked in large international firms and also lectured in administrative law, Asian law, commercial law, European Union law, international law and trade practices at a number of Australian universities.

Ricky has published extensively on international law, commercial law and technology law and has presented legal and technical papers at international conferences, including speaking at a number of United Nations intergovernmental workshops. He is a Fellow of the Commercial Law Association, a Director of the International Institute of Space Law and a Member of the Section on Business Law of the International Bar Association.

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