Mr Peter Hallahan
Committee Secretary
Standing Committee on Legal and Constitutional Affairs
Parliament House
CANBERRA

Inquiry into the Personal Property Securities Bill 2009

I am grateful for the Committee's invitation to make a submission to the Inquiry.

Last Saturday, I gave a paper to the 26th Banking and Financial Services Law Association Conference in Queensland in which I dealt with the purchase money security interest, the concept of value and the duty to act in a commercially reasonable manner. Accordingly much of the time that I have had to consider the Bill has been taken up with those issues.

The Bill is a vast improvement on the Exposure Draft in the sense that the Bill has been simplified and some of the provisions have been more closely aligned with the New Zealand provisions and the Saskatchewan provisions from which the New Zealand provision derives. Despite this there are still a magnitude of errors and inconsistencies. It is not possible to deal with many of them in the short time that I have had to consider the Bill. What follows is a few specific comments on the Bill.

What is immediately obvious to the reader when making a comparison of provisions is the reworking of provisions in the overseas models simply for the sake of style. New language and new terms are used so that it is not easy to determine whether there has been a change of meaning. This approach is re-inventing the wheel for the sake of it. When considering a provision it is necessary to look at the provision itself, the New Zealand equivalent and the Saskatchewan version in order to see the tired and true provision. In some cases it is also necessary to look at the Article 9 (2001 Revision) provision in order to see what it says and what it is trying to achieve where the Canadian statutes and the New Zealand legislation do not have an equivalent.

In my previous submission I mentioned a number of concerns and some of these concerns, co-mingling, leasing, registration of a filing statement, debtor/grantor, etc appear to have been addressed. Fixtures and crops are still unsatisfactory.

The purchase money provisions provide an example of the methodology adopted by the draftsman. The provisions have been improved and at the same time made confusing. The word 'seller' has been removed from s14(1)(a) for an unknown reason.

PMSIs have two main applications. First, a seller to the extent that the security interest secures all or part of the purchase price. Secondly, for enabling loans where value is given to enable the debtor to acquire rights in the collateral to the extent value is applied to acquire those rights. A PMSI also extends to leases and consignments.

In Saskatchewan, a PMSI priority does not apply to investment property. Under the Bill, chattel paper, investment instruments, investment entitlements, monetary obligations and negotiable instrument have been excluded. The super priority accorded a PMSI applies to the collateral and its proceeds. The proceeds quite often are represented by chattel paper or a monetary obligation (a account).

A sale and leaseback is excluded because such a transaction does not enable a debtor to increase his pool of assets. For some inexplicable reason s14(2)(c) excludes consumer collateral. This is clearly a mistake. Under the North American models PMSIs in consumer goods enjoy a super priority with automatic perfection. Also, in relation to consumer property where it involves serial numbered goods, the financing statement must include the serial number. The inclusion of the serial number is optional with inventory. The buyer in due course provisions are designed to protect consumers so that the inclusion of a serial number is not important with inventory but it is with equipment or consumer property.

The Bill does not refer to 'consumer property' rather it uses the long-winded expression 'intends to use predominantly for personal, domestic or household purposes. Section 20 still refers to consumer property, commercial property and equipment as categories of property. Canada, New Zealand and Article 9 refer to consumer property, inventory and equipment throughout their legislation as the three categories of personal property. In the Bill the draftsman is still not sure whether property is consumer property or property used for personal domestic or household use are one and the same thing. He or she also uses commercial property and equipment instead of inventory and equipment. Consumer property is defined in the Bill to be personal property used by an individual other than in a commercial enterprise to which an ABN has been allocated. Rather it should be used predominantly for personal, domestic or household purposes. The same meaning as the Consumer Credit Code, etc.

Saskatchewan and New Zealand define purchase price and value to include credit charges and interest payable. By way of contrast the Bill adds a subsection (c) to the definition of value in s10 which provides that it has the meaning affected by section 14. Section 14(8) provides the same meaning. Section 14(7) is otiose because of s14(1). This drafting is confusing and adds to the complexity of the Bill.

The inclusion of the mixed security provisions in s14(3) and (4) are laudable in respect of the intention to deal with the difficult priority aspects as is the inclusion of s14(5) dealing with renewals, refinancing, consolidation, etc.

Section 14(5) provision is borrowed directly from Article 9-103(f)(3) and is satisfactory to deal with the former problems in North America involving the conflicting judicial approaches between the transformation principle (PMSI status is lost) and the dual status principle (a PMSI and non-PMSI collateral are permitted to exist side by side) that occurs when a PMSI is cross-collateralised with a general security agreement.

The mixed security provisions in the Bill appear to be less successful and are badly drafted. I set out in full Article 9-103(f) so that the Bill's approach can be contrasted with a tried and true approach.

"In a transaction other than a consumer-goods transaction, a purchase money security interest does not lose its status as such, even if:

(1) the purchase-money collateral also secures an obligation that is not a purchase-money obligation;
(2) collateral that is not purchase-money collateral also secures the purchase-money obligation; or
(3) the purchase-money obligation has been renewed, refinanced, consolidated, or restructured."

The Bill also does not deal with a problem that arose in the *Chrysler* decision in Canada. The effect of *Chyrsler Credit Canada Ltd v Royal Bank of Canada*[1] decision is that the moneys can be tacked (added) onto the other PSMI collateral. As a matter of principle this decision was wrong. Each PMSI is a stand alone security because of the words "to the extent that" in s14(1).

The effect of the *Chrysler* decision has been reversed in s34(9) of the Saskatchewan legislation. That section provides that a PMSI *in an item of collateral does not extend to or continue in the proceeds of an item after the obligation to pay the purchase price of the item or to repay the value for the purposes of enabling the debtor to acquire rights in it has been discharged*. The result of this is that the prior general security holder picks up the equity in the collateral after repayment of the PMSI obligation because he is first in time. There is no equivalent of this provision in the Bill.

Unlike Canada[2] there is no requirement for the secured party to give notice to other secured parties before advancing funds against inventory. The purpose behind the notice provisions in Canada is to warn existing secured parties that the PMSI financier is going to provide funds to enable the debtor to increase his stock so that they will not make further advances against swelled stock in the belief that the debtor has enhanced his asset base. Normally an existing secured party would search before making a further advance to ensure that no purchase money security interests have been registered. It is impractical for a general security holder to search before each advance but he will be forced to so do because of the removal of the notice procedure.

By dispensing with the notice requirements, inventory financiers are treated in the same way as non-inventory financiers. Given its purpose it is difficult to see the rationale for removing the notice procedure.

The Bill instead provides that in order to secure priority as a PMSI in inventory or proceeds, the inventory financier must perfect his security interest *before* the

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[1] [1986] 6 WWR 338 (Sask CA).

[2] Eg s34(3) Saskatchewan.

debtor obtains possession of goods[3] and that the filing statement must state that the security interest is a purchase money security interest: s62(2)(c). There is a 10-day window for registration for non-inventory PMSIs *after* possession. In the case of other collateral (intangibles), attachment is sufficient.

Chapter 4 dealing with remedies is also problematic. The Bill limits commercial reasonableness to this Chapter (s111). In order for the Committee to see the difference in treatment under other jurisdictions I set out the differing provisions below.

The New Zealand Act (s25) provides:

> (1) All rights, duties, or obligations that arise under a *security agreement or this Act* must be exercised or discharged in *good faith* and in accordance with *reasonable standards of commercial practice*.
> (2) A person does not act in bad faith merely because the person acts with knowledge of the interest of some other person.

The Saskatchewan Act (s65(3) and (4)) provides:

> (1) All rights, duties or obligations that arise pursuant to a *security agreement, this Act or any other applicable law* are to be exercised or discharged in good faith and in a *commercially reasonable manner*.
> (2) A person does not act in bad faith merely because the person acts with knowledge of the interest of some other person.

As will be apparent, Saskatchewan applies commercial reasonableness to obligations under the Act, the security agreement and any other applicable law. New Zealand limits its application to obligations under the Act or under the security agreement. Because the reach of the duty extends to obligations and duties under the Act and the security agreement subsection (2) is included. Subsection (2) is particularly relevant to priorities which arise under the Bill and is therefore otioise.

The standard set by the duty has two aspects, namely, honesty and commercial reasonableness. Neither concept is defined and no guidance is given as to what good faith or honestly mean in this context. Neither good faith nor honesty is defined in the Canadian legislation. It is generally accepted that it has the same meaning as in the *Bills of Exchange Act* 1909 (s96).

Article 9 itself does not define good faith but the definition is to be found in UCC §1-201(20). It is defined to mean "honesty in fact and the observance of reasonable commercial standards of fair dealing".

Professor Gilmore[4] says that the "secured party's overriding obligation is to act (as the Code puts it) in a 'commercially reasonable' manner, or (as judge

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[3] In a case where perfection is effected by possession by the SP, registration will not be required until possession is given to the debtor. The filing statement should be lodged before possession is given to the debtor.

[4] Security Interests in Personal Property (1965) vol 2, p1234.

Desmond put in *Kaimie*[5]*)*, 'in good faith', or (as Judge Learned Hand, citing *Kiamie*, once put it) with a 'reasonable regard for the pledgor's right' ".

The good faith standard in *Pendlebury*[6] seems to represent the common law standard of care for a mortgagee in Australia and may be stated as imposing an obligation on a mortgagee to exercise his power of sale in good faith having regard to the interests of the mortgagee but not disregarding the interests of the mortgagor[7].

Croft and Johannsson[8] summarise the following matters as part of the mortgagee's duty:

1. the mortgagee is not a trustee.
2. a mortgagee is entitled to realise his security by selling the collateral as and when he chooses (subject to any notice requirement) except where the timing would cause manifest unfairness.
3. Power to be exercised in good faith taking into account the mortgagees interest but not ignoring those of the mortgagor.
4. Mortgagee is bound to obtainable the best price obtainable.
5. The mortgagee owes no duty that would make it liable for mere negligence or carelessness. The position appears to be different in New Zealand as a certain degree of negligence or carelessness might put the mortgagee in breach of it duty to obtain the best price.
6. The duties in relation to land registered land (Torrens title) are generally the same in relation to general law land. It is clear that the common law duty also extends to personal property and where the powers of sale is being exercised by a receiver the duty is owed to the creditors generally[9].

Obtaining a proper or fair price or fair market value of the property being sold is simply part of the duty to act in good faith. In *Latec Investments Ltd v Hotel Terrigal Pty Ltd*[10] Kitto J though that the mortgagee's duty of good faith was satisfied if the mortgagee took reasonable steps to obtain a fair value on sale.

In Canada, the general duty seems to be to take reasonable care to obtain the true market value[11]. True market value and proper price[12] seem to be one and

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5 *In re Kiamie's Estate* 309 NY 325, 330, 130 NE 2ed 745, 747 (1955).

6 *Pendelbury v Colonial Mutual Life Assurance Society Ltd* (1912) 13 CLR 676.

7 Croft and Johannsson *The Mortgagee's Power of Sale* 2ed (2004) at 145.

8 *Op cit* at 144-145.

9 *Expo International Pty Ltd v Chant* [1979] 2 NSWLR 820.

10 (1965) 113 CLR 265 at 273.

11 *McHugh v Union Bank of Canada* [1913] AC 299 PC.

12 Cf *Goldcel Nominees Pty Ltd v Network Finance Ltd* [983] 2 VR 257 where Murphy J thought that the statutory duty was to obtain the best price at 261-262.

the same thing[13]. Here in Australia, s96 of the Consumer Credit Code imposes an obligation to obtain the best price reasonably obtainable.

Commercial reasonableness unlike good faith seems dependent on an understanding of what is considered reasonable by those involved in a particular industry or practice under scrutiny as opposed to a subjective understanding of a particular person whose conduct is in issue.

It is probably fair to say that the obligation to act in good faith or honestly in a commercially reasonable manner is a higher burden than that imposes on the mortgagee at general law and also by statute in relation to land.

Commercial reasonableness is the sense that it imposes an obligation to get the best price or true market value is in a sense made meaningless by s131 (NZ s110). There is no equivalent in Saskatchewan's legislation. This duty will apply to commercial property in the Bill (ie inventory and equipment) but not to consumer property regulated by the Uniform Credit Code. The Uniform Credit Code imposes an obligation to get the best price reasonably obtainable as mentioned above. Section 129 should refer to personal property that is not consumer property. This provision is taken from s59(13) of the Saskatchewan Act. New Zealand does not have an equivalent.

It is probably true to say that the duty in s111 is circumscribed by the duty is s131 to get the best price or the true price.

A further difficulty with the duty in s111 is the ability of a secured party to contract out of the certain enforcement provisions (s115) other than s111. Also Chapter 4 does not apply to property while under the control of a receiver or receiver and manager or a controller (s116). This is an odd provision and probably renders the duty nugatory given the receiver will undoubtedly be exercising the rights and remedies that the secured party has and will be realising the assets of the debtor under the security agreement as agent for the debtor. This should not make a difference. The general law duty to act in good faith will apply.

It is extremely difficult to understand the reason for applying the Corporations Act receivership provisions to corporations that do not imply a duty to act honestly and in a commercially reasonable manner while retaining the duty for individuals.

The duty is further undermined if the obligations are secured over both personal property and land as a secured party may exercise the higher priority security under s117 and apply the law relating to land law decisions under s118(3). The Saskatchewan equivalent (s55(4) seems to says that you can use the land procedure but the duty still applies because the good faith and commercial

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[13] *Cuckmere Brick Co Ltd v Mutual Finance* [1971] Ch 949 Salmon LJ at 968. *Cuckmere* seems to have been accepted as the law in New Zealand by the Privy council in *Downsview Nominees Ltd v First City Corporation* [1993] AC 295 (as case dealing with receivers) but there is no negligence standard involved.

reasonableness applies to the Act, the security agreement and any applicable law.

It is difficult to understand the basis for having two different standards depending on whether a debtor is a corporation or an individual. Also it is difficult to see any rationale basis for having a differing standard for personal property and another for land. It would be better to say that in Chapter 4 a secured party includes a receiver and s111 should apply.

If the duty in s111 is higher than that for land and higher than that imposed on a mortgagee by the general law then it is not an appropriate measure despite the expression of the duty in Canada, New Zealand and under Article 9.

Part 2.5 is confusing. The main rule in s43 appears to be modelled on New Zealand's s52 but it has been changed in a number of respects with no apparent explanation or policy basis. The New Zealand section provides that a buyer or lessee of collateral for value takes free of an unperfected interest in the same collateral. Section 43 uses the words 'personal property' in place of 'collateral' and the words 'new value' in place of 'value'. New value in s10 means value other than value provided to reduce or discharge an earlier debt or liability.

The ordinary course of business provision in s46 (NZ s53) is likewise different. It refers to personal property (NZ refers to goods). The cut-off or extinguishment provision in the Bill limits the sale to one in 'the ordinary course of business of selling or leasing personal property of that kind'. By contrast the New Zealand provision refers to 'goods sold in the ordinary course of business of the seller'.

Section 44 deals with serial numbered personal property where the serial number is missing or not properly described in the financing statement. Cf serial numbered goods or equipment not correctly described by serial number in s55 (NZ). Section 44 does not classify personal property by reference to its use in the same way as New Zealand and also adds the requirement for new value. New Zealand does not follow the Saskatchewan provisions (s30(6) and (7)) that limit such a sale or lease of goods by reference to new value. Saskatchewan also provides that value can be cash, an exchange for other property, or credit. The Bill's provision is not as simple as is New Zealand's and it suffers from extremely complicated drafting.

I am also still troubled by the concept of perfection by control in relation to ADIs. ADIs enjoy a special position because of combination of accounts and set off by virtue of by their status as a bank. ADIs will enjoy a situational monopoly over deposits because of the combination of perfection by control and set off. This is anti-competitive. In my view it is best that perfection by control should not be permitted by ADI with whom an account is held. ADIs should be obliged to register a filing statement so that other financiers know by searching that the ADI has a security interest in that account above and beyond its rights of set off and combination. Flawed-asset arrangements with ADIs should also be treated as security interests that must be perfected by filing.

These are but a few examples of confusing provisions and questionable policy choices and demonstrate a failure to follow what are tried and tested provisions that are simple to comprehend. These provisions do not assist a financier who is to take security from a company or an individual who operates on both side of the Tasman Sea.

David C Turner
Barrister
Owen Dixon Chambers West
Melbourne
5 August 2009