

Our ref: PRF01:0256424

9 December 2008

The Committee Secretary
Senate Legal & Constitutional Affairs Committee
Department of the Senate
PO Box 6100
Parliament House
CANBERRA ACT 2600

Dear Sirs

Inquiry into the Personal Property Securities Bill 2008 [Exposure Draft]

DLA Phillips Fox (**we**) provide below our comments in relation to the Personal Property Securities Bill 2008 [Exposure Draft] (**Revised Bill**) for your consideration.

In providing these comments, we have taken account of the original Consultation Draft of May 2008 (**Consultation Draft**), our previous submissions on the Consultation Draft (and indeed the previous Discussion Papers) and the objectives of the Personal Property Securities Reforms being to:

- increase certainty,
- increase consistency,
- reduce complexity, and
- reduce costs.

Our comments are also based on what we believe should be a fundamental principle of the personal property securities reforms, which is that secured creditors should not be worse off as a result of the operation of the new regime.

Executive Summary

Complexity and structure

- 1 One of the prime objectives of the PPSR is to reduce complexity and reduce costs.

- 2 Despite this, there are many instances in the Revised Bill where the meaning of sections or particular terms are unclear. Examples include the term 'single authoritative copy' appearing in section 43(5), the concept of 'rights arising out of the collateral' and 'property collected on the collateral' referred to in section 42(1)(d), the meaning of investment entitlements (section 54) and leases securing payment or performance obligations (section 30) and the purpose of sections 233(3) and (4).
- 3 In addition, and perhaps more importantly, the substantial number of circumstances expressly dealt with in the priority rules (sections 100–123 and sections 128–148) and other parts of the Bill (such as Division 6 of Part 2.2 and Division 1 of Part 4.3) in our view makes the legislation unnecessarily complex. The large number of circumstances dealt with by various provisions of the Bill (and which do not relate to common commercial situations) in many instances makes it difficult to understand the intended operation of the Bill as there seems to be inconsistencies between provisions (see discussion below on Extinguishment of security interests - particularly at points 15 - 17).
- 4 A further example of the complexity of the Bill is the operation of the Transitional Provisions (Chapter 7).
- 5 While we applaud the desire to assist people in determining the application of the Bill to a large number of circumstances, we believe that this detracts from the simplicity of the Bill which should be limited to the main circumstances to which it will relate. Circumstances which do not arise often should be dealt with by Regulations as and when particular circumstances become known as requiring legislative consideration. In our view, it would be preferable for the Revised Bill to provide for a simpler, more understandable framework within which financiers and their clients can operate to determine their respective positions in relation to circumstances which commonly arise in day to day commerce. To the extent that circumstances change due to developments in the market and/or the creation of new products, these can be regulated through the issue of appropriate Regulations at the relevant time.

Impact on leasing industry

- 6 The Revised Bill (and the Personal Property Securities Reforms (PPSR) generally) will have a significant impact on the leasing industry. As a lease of tangible property (whether or not a PPS lease) is to be regarded as a security interest for the purposes of PPSR, we believe it is essential that participants in the leasing industry have clear guidelines as to whether or not the leasing arrangements they enter into are caught by the Revised Bill.
- 7 We believe that the provisions of the new section 30 are unclear as to when a lease is to be regarded as securing payment or performance obligations. Statements that the determination of this issue is by reference to the 'facts of each case' as well as the guidelines given in subsections (2) and (3) are unclear.

Uncertainty as to operation of national scheme

- 8 A key objective of PPSR is to provide a single national system for the creation, registration and enforcement of security interests over personal property. Indeed,

much has been said of the benefits of such system relative to the 70 or so pieces of State legislation which has been indicated as requiring consideration in relation these transactions. Accordingly, we find it strange that through the operation of various provisions contained in the Revised Bill, in particular sections 15 and 21 (and the uncertainty as to how these sections interact with sections 22–25 of the Revised Bill) there would not appear to be any certainty that the system provided for by the Revised Bill will be the only scheme requiring compliance to effectively create and enforce a security over personal property.

We have not considered the constitutional issues arising from these provisions or indeed the proposed operation of the Revised Bill, however believe that it is imperative (in order to achieve the desired result for the scheme) that it not be implemented until all States and Territories have referred the requisite powers to the Commonwealth and are not entitled to exclude matters from the operation of the Bill.

Exclusions from PPSR

- 9 A number of arrangements have been removed from the operation of PPSR by section 6 of the Revised Bill. In other cases, although the express inclusion of certain arrangements within the meaning of security interest (in section 28(2)) have been removed (such as flawed asset arrangements and security trust instruments), they have not been expressly excluded from the operation of the Revised Bill in section 6. This still leaves open the possibility that such arrangements are caught within the general meaning of security interest contained in section 28(1) (which we assume is not intended). Accordingly, we recommend that such arrangements be expressly excluded from the operation of the Revised Bill in section 6.

Investment entitlements

- 10 The concept of investment entitlement has been significantly amended in the Revised Bill, however, it is unclear why it has been necessary to do so. Investment Entitlements are now regarded as a specific form of personal property which has been included in various provisions of the Bill.

Is it the view of the Committee that the existing concepts such as investment instrument, negotiable instrument, chattel paper and/or accounts do not sufficiently deal with the circumstances intended to fall within the meaning of 'Investment Entitlement'?

Extinguishment of security interests

- 11 We are concerned that notwithstanding a national registration system, there are numerous provisions in the Revised Bill (and indeed the Consultation Draft) which allow third parties to obtain an interest in the personal property the subject of a security interest granted to a creditor without being subject to it. A fundamental reason why this can occur is the absence of knowledge of the existence of the security interest or the restrictions contained in it. This fundamentally is a result of the absence of constructive notice of the existence of such security interests, even if they are registered.

Although it will be prudent (and will no doubt become standard practice amongst reputable financiers) for financiers seeking to take security over personal property to do a search of the register, there is no obligation on any party to undertake such search. While we applaud the amendments to section 56 (being the successor to section 41 of the Consultation Draft) which substantially clarifies when a person has knowledge, it is still unclear whether a search of the PPS register is to be seen as an enquiry that 'would ordinarily have been made by an honest and prudent person'.

This is particularly so where the party seeking to rely on absence of knowledge is not in the business of providing finance. We accept that prudent financiers will undertake such searches and as a result, it will be an enquiry which will ordinarily be made by an honest and prudent financier, however we are not sure whether this will apply to persons who are not in the business of providing finance or purchasers of personal property.

Perhaps the Revised Bill can incorporate an obligation for such search to be undertaken or, alternatively, deem the requirement to undertake such search as being an enquiry that should ordinarily be undertaken by a person seeking to take security over personal property or seeking to acquire personal property (other than perhaps consumer property). If this concept was accepted, section 57 could be replaced by such provision.

- 12 A number of provisions allow third parties to obtain an interest in collateral free of existing security interests if they do not have actual knowledge that the transaction by which they obtained their interest is a breach of the security agreement by which the existing security interest was created (see sections 86, 87 and 116). As a security interest generally prohibits dealings with the collateral the subject of it, except in relation to assets subject to a floating charge or circulating assets, we cannot see why these provisions rely on actual knowledge rather than knowledge, as extended by section 56. By relying on actual knowledge, it will be very difficult for the existing security interest holder to prove that the third party had such knowledge, which will result in the existing security holder losing its security interest over the relevant collateral.

Accordingly, thought should be given to using the broader concept of knowledge, as provided for in section 56, in these sections. See our further comments on section 116 in point 24 below.

- 13 A further area of concern in the Consultation Draft (section 69) and now the Revised Bill (section 73) is the possibility of the original security holder losing its security interest in personal property which has been transferred by the grantor of the security to a third person (who has granted a security interest over the same personal property to a further financier). This will apply irrespective of whether or not the transfer of the personal property was prohibited by the original security interest. This raises the issue of whether or not the second security holder should be entitled to claim that it has obtained its security interest in the personal property without being subject to the original security interest.

If the holder of the second security interest was required to undertake a search of the register, it would not have accepted its security interest without first obtaining a discharge of the original security holder's security interest.

- 14 Section 73 is not currently qualified by reference to whether or not the second security holder has acquired its interest with or without the knowledge of the first security interest.
- 15 Section 73 seems to allow for the original security holder to maintain its priority position only for five business days after which its security interests will become unperfected and thereby lose priority to the second security holder. In circumstances where the dealing with the personal property was prohibited by the original security agreement, it is not likely that the original security holder will make any enquiry as to whether or not such dealing has occurred and therefore it is likely to lose its priority in these circumstances.
- 16 In addition, section 73(3) provides that the original security interest will become unperfected. It is not limited to the particular circumstance referred to but seems to make the original security interest unperfected for all purposes. This should not be the case as the original security interest may extend to other collateral which has not been transferred and in respect of which it should remain a perfected security interest.
- 17 We do not believe that this is appropriate. Indeed, section 73 is inconsistent with section 115 which preserves the priority of the original security holder. Accordingly, the second security holder should not be entitled to obtain any priority, particularly if it has either actual knowledge or knowledge as otherwise provided in section 56(2)(b) of the Revised Bill.

Purchase Money Security Interests

- 18 Section 110 provides a purchase money security interest holder over non-inventory priority over existing security interests granted over such non-inventory. Under this provision, no notice is required to be given to the existing security interest holder whereas in relation to inventory, section 109 requires such notice to be given. In our view, as non inventory is not a circulating type asset, it is not appropriate that a purchase money security interest should have priority over an existing security interest over non-inventory. We also refer to our comments on knowledge and constructive notice as set out above.

Encouragement of breach of security interests

- 19 We have previously raised the concern as to the operation of section 116 of the Consultation Draft (now section 124 of the Revised Bill) which provides a statutory right for a grantor of the security interest to transfer the assets the subject of that security interest without seeking the consent of the secured party (even if the relevant security agreement contains a prohibition on such transfer). Although the section does not prejudice the rights of the secured party under the security agreement, we do not understand why such a statutory right should be included in the legislation. We are concerned that the wording may imply to grantors of securities and transferees that notwithstanding the existence of security interests

over assets, such assets can be transferred without seeking the approval of the holder of the relevant security interest. As this is fundamentally what is intended to be prevented by entering into a security agreement, we suggest the section be deleted. If there is any specific type of personal property where it has been seen fit to deal with this issue, then the section should be limited in operation to that type of personal property.

Duty of security holder on enforcement too broad

- 20 Section 169 imposes a duty on a secured party to obtain at least market value for the collateral on disposal (on enforcement) or, if the collateral does not have a market value, to obtain the best price that is reasonably obtainable at the time of disposal, having regard to the circumstances existing at that time.

Although the obligations are similar to that contained in section 420A of the *Corporations Act*, the opening paragraph of section 169 may result in the secured party owing duties to a broader range of persons than is currently the case. In particular, the duties are owed to any person who has an interest in the collateral. The term 'interest' is unclear and given the consequences of failure to comply with this duty, we recommend that this section be redrafted so that the persons to whom such duty is owed should be limited to the persons referred to in section 168(1).

This is particularly important given the entitlement to damages against secured parties contained in section 236. Secured parties should be clear as to who they owe duties to.

Insolvency related issues

- 21 The revised provisions dealing with avoidance of security interests in circumstances of insolvency raises a number of concerns. As there is no timeframe within which a security interest must be registered or otherwise perfected, it is possible for security interests to be created which will not be registered. Although the holder of such security faces the risk of the security interest being void against a trustee in bankruptcy, liquidator or administrator, the lack of an obligation to register the security interest will detract from the efficacy of the register.
- 22 Of course, the holder of such security interest also risks losing its priority position but we note that priorities are based on perfection and that perfection can (in the case of certain property) be by way of possession or control as well as registration.
- 23 Essentially, the new provisions will require a security interest to be perfected as soon as possible after their creation.
- 24 A further matter relating to insolvency is the operation of section 116 of the Revised Bill. This provides a creditor (be it secured or unsecured) with a priority over a secured creditor in the circumstances mentioned in the section. This would appear to be inconsistent with the operation of the unfair preference provisions of the *Corporations Act* where payments received by unsecured creditors can, in certain circumstances, be held as voidable. It is not clear that section 116 is subject to the operation of the *Corporations Act*.

- 25 Section 233(2) provides that a security interest which is unperfected at the time of insolvency vests in the grantor of the security interest immediately before the relevant insolvency event. If the terms of the security interest are the only basis on which a security holder may take action against the grantor of the security or lodge a proof of debt with the relevant insolvency administrator, we are concerned that this provision will result in certain secured creditors losing all rights to seek damages or lodge proofs of debt in the insolvency administration of the provider of the security. As this should not be the outcome of the security interest being unperfected (as it should only impact on the priority position vis-à-vis the administrator, liquidator or trustee in bankruptcy) this section should be deleted.
- 26 We are also concerned that sections 233(3) and (4) are unclear as to their meaning or purpose.

Holders of personal property security interests should not be entitled to disrupt enforcement under land law

- 27 Sections 155–157 of the Revised Bill deal with circumstances (which are quite common) where a secured creditor has security over both the land held by the grantor of the security as well as a charge over all of its assets (including personal property). In those circumstances, these provisions allow the holder of that security to determine whether or not it will enforce its securities under land law or under the personal property securities regime. While we applaud the flexibility allowed for by these provisions, other secured parties, who may only have personal property securities, are at liberty under section 157(6) to disrupt the enforcement process undertaken by the first secured party in relation to the land as well as the personal property. In particular, subparagraph (c) of that subsection allows the other secured party to apply to a court in relation to the land for the conduct of a judicially supervised sale. We do not believe it is appropriate for the other secured party to disrupt the enforcement process applicable to the land, and accordingly, this provision should be deleted.

Detailed Comments

We attach to this letter a schedule of more detailed comments on the Revised Bill which are intended to assist in clarifying certain issues and streamlining the drafting so as to facilitate the Bill achieving the desired results (as mentioned at the beginning of this submission).

We would be more than happy to discuss the above matters and those in the attached schedule with you.

Yours sincerely



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Schedule

Detailed Comments

Personal Property Securities Bill 2008 [Exposure Draft] (Revised Bill)

- 1 Both flawed asset arrangements and security trust instruments should be expressly excluded from the operation of the Bill under section 6.
- 2 It is unclear whether sections 22–25 are subject to section 21. This should be clarified.
- 3 Although an account that is not an ADI account but is the proceeds of inventory and also inventory are types of personal property that can be subject to control (see definition of 'control'), they are not controllable property (as they are not included in the definition of 'controllable property'). Is this intended? Should the definitions of 'control' and 'controllable property' be aligned?
- 4 Section 30 is unclear as to its operation and given it has a significant impact on the leasing industry and the application of the PPSR to that industry, thought should be given to a clearer definition. We are particularly concerned with the guidelines currently contained in subsections (2), (3) and (4).
- 5 The concept of 'chattel paper' has been removed from sections 39(2) and 41(2). Previously, these provisions expressly excluded chattel paper from the meaning of 'investment instrument' and 'negotiable instrument'. It is unclear why the term was removed from these provisions.
- 6 The meaning of section 42(1)(d)(ii) and (iii) is unclear. This should be clarified.
- 7 The concept of 'a single authoritative copy of the record' referred to in section 43(5)(a) is unclear. What is proposed? In what circumstances would this exist? It is not uncommon for documents which fall within the meaning of a 'chattel paper' to be prepared in duplicate.
- 8 The Consultation Draft referred to the secured party rather than the 'possessor' mentioned in section 44. We believe that the Consultation Draft was correct and query why it has been replaced by the word 'possessor'.
- 9 The words 'and only if' have been removed from the end of the second line of section 45(2). We note that section 45 does not contain an equivalent to section 46(4) and accordingly it would seem that the words 'and only if' should be reinstated after the words 'evidenced by a certificate if' appearing on line 2 of section 45(2).

- 10 In our view section 53(1)(b) should be amended so as to read as follows: *'the secured party's usual practice is to require the grantor to comply with the agreement'*.
- We believe that the section is intended to refer to the secured party's practices rather than the grantor's practices.
- 11 It would be helpful if examples of items which are to be regarded as investment entitlements (section 54) were included as a note at the end of section 54(1) as it is unclear as to what types of personal property this is referring to.
- 12 As to our thoughts on constructive notice of security interests registered on the register (section 57), please see our covering letter.
- 13 The note currently appearing at the end of section 58 should be incorporated in the Revised Bill as a section rather than merely a note. This would be consistent with Consultation Draft.
- 14 Section 60(4) should be deleted as we do not understand its purpose. The matters dealt with would appear to already be covered by section 60(1).
- 15 Under the Consultation Draft, in order for a security interest to attach to personal property, the secured party was required to provide the value for the security interest. This is no longer required and is merely one of two options (see section 61(1)(b)). It is unclear why this amendment was made.
- 16 It is unclear whether section 63(2) must be complied with in addition to the matters referred to in section 63(1) or whether they are alternatives. This ambiguity needs to be clarified.
- 17 We query why section 68(4) is required in the Revised Bill. Clearly, a security holder can only recover amounts which are owing to it and we do not see why such provision needs to be included.
- 18 Please see our covering letter in relation to our comments on section 73 (particularly given the operation of section 115).
- 19 The temporary perfection referred to in section 77(2) should allow for an extension of the five business day period to account for potential delays in completing the dealings allowed for.
- 20 Division 6 of Part 2.2 of Chapter 2 is unclear and we believe it would assist in understanding the intention of the provisions if examples were included by way of note.
- 21 Section 84(2)(b) provides that the provisions contained in Division 1 of Part 2.3 apply irrespective of whether the secured interest is perfected or not. As a perfected security interest should theoretically provide a security holder with the strongest form of security interest, we query whether this is correct. Once again, please refer to our covering letter in relation to the discussion relating to extinguishment provisions.

- 22 As mentioned in our covering letter, we do not believe section 116 is appropriate as it inconsistent with the unfair preference provisions of the *Corporations Act*. We note section 116(1) does not provide the unsecured creditor with priority if it had actual knowledge that the payment was made in breach of the security agreement. See our comments in relation to constructive notice and extinguishment of security interests as contained in our covering letter.
- 23 Section 120(4) should be deleted as this appears to be no longer relevant (due to the removal of fixtures from the Revised Bill).
- 24 Section 110 provides a purchase money security interest holder over non-inventory priority over existing security interests granted over such non-inventory. Under this provision, no notice is required to be given to the existing security interest holder whereas in relation to inventory, section 109 requires such notice to be given. In our view, as inventory is more of a circulating asset than non-inventory, it makes no sense that a purchase money security interest should have priority over an existing security interest over non-inventory. We also refer to our comments on knowledge and constructive notice as set out in our covering letter.
- 25 As to our comments in respect of section 124, please see our covering letter.
- 26 Section 125(3) provides that an account debtor and the transferor can make arrangements which modify the contract between the account debtor and the transferor. Apart from the restriction in subparagraph (c), such modification would appear to be binding on the transferee (notwithstanding that the contract has been transferred). Any amendments made subsequent to the transfer of the contract should not be binding on the transferee and indeed the account debtor should not be in a position to make amendments with the transferor once notice of the transfer has been provided to the account debtor. At the moment, section 125(4) expressly provides that the modifications will apply notwithstanding that there has been notice of the transfer to the account debtor.
- 27 We refer to our covering letter as to our concerns in relation to the ability of a secured party to disrupt enforcement proceedings of a prior ranking secured party which has chosen to enforce under land laws rather than the Revised Bill (section 157(6)).
- 28 Section 158 may require modification given the proposed transfer of the regulation of all credit to the Commonwealth Government.
- 29 It is unclear whether section 159(1)(a)(iii) extends to shares and units in managed investment schemes. The qualification in the reference to investment instruments or investment entitlements to 'provide an obligation to pay the grantor' does not fit well with those types of securities. If it is intended to be subject to this provision, those words should be deleted.
- 30 It is unclear whether section 161(2) is in addition to section 161(1) or whether the two sections can operator as alternatives. If section 161(1) is an alternative to section 161(2), it is unclear whether the balance of the provisions in Part 4.3 of Chapter 4 would apply. At the moment, the balance of the provisions make no distinction between sections 116(1) and 116(2).

- 31 The table in section 191 and the Revised Bill generally continues to refer to subordination rather than priority. The reference in item 7 of the table in section 191 to subordination is in fact a reference to a Deed of Priority between secured creditors. Subordination is a different concept which refers to the agreement of a creditor not to require payment of debt prior to payment in full of other indebtedness. Subordination does not rely on the existence of a security interest. We assume that the term 'subordination' is used rather than 'priority' due to the reference to 'priority' amongst secured creditors in numerous provisions of the Bill. Accordingly we suggest that the term subordination be specifically defined in section 26 by reference to an agreement between security holders relating to the ranking of their various security interests. See also section 29.
- 32 As to our comments in relation to insolvency-related provisions, please see our covering letter.

Yours sincerely



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