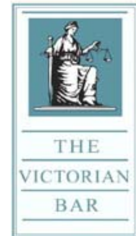

PERSONAL PROPERTIES SECURITIES (PPS) BILL
EXPOSURE DRAFT - 10 November 2008

SUBMISSIONS ON BEHALF OF THE VICTORIAN BAR 24 APRIL 2009

Background to Submissions

1. On 18 November 2008 the Victorian Bar received an invitation by email from the Australian Attorney-General's Department to provide written submissions to the Senate Standing Committee on Legal and Constitutional Affairs in relation to a revised draft of the Personal Properties Securities Bill, namely, exposure draft of 10 November 2008 ("the Exposure Draft"). This email was forwarded to Maryanne Loughnan on the same day as Chair of the Banking & Finance Section of Commercial Bar Association. The submissions were sought by 10 December 2008.

2. The background to this invitation was that the Banking & Finance Section had prepared submissions on behalf of the Victorian Bar in relation to draft Regulations under the Bill at the invitation of the Australian Attorney-General's Department on 31 October 2008. These were prepared by Maryanne Loughnan, Peter Fox and Lana Collaris.

3. The task of preparing submissions in relation to the draft Regulations was a relatively narrow one, being confined to certain questions regarding specific proposed regulations. Up to this time the Attorney-General's Department had never made a direct invitation of the Victorian Bar to comment on any draft of a PPS Bill - the first draft of which had been released in May 2008. The Exposure Draft is nearly 300 pages in length and embraces the most comprehensive reform of property law since the statutory regime which introduced Torrens title.

4. The proposed reform is far more complex than Torrens title legislation as it picks up a vast range of the categories of personal property, many of which have their own peculiar forms of security law. Maryanne Loughnan prepared submissions on behalf of the Victorian Bar in May 2007 ("the VicBar May 2007 Submissions") and June 2007 ("the VicBar June 2007 Submissions") in relation to Discussion Papers 2 and 3 respectively of a proposed draft of the Bill.

5. Preparation of submissions in the timeframe specified in paragraph 1 above was not achievable. On 4 December 2008 Maryanne Loughnan contacted a Legal Officer in the Attorney-General's Department assisting the PPS Branch and told her that the Victorian Bar could not respond in the timeframe and that it was more than willing to assist in the future. She was then contacted by Luke Brown, Acting Senior Legal Officer, PPS Law, Attorney-General's Department. He expressed a strong desire that the Victorian Bar provide its comments in relation to the Bill in the early part of 2009 as the Department would be drafting up to the time of the planned introduction of the Bill to Parliament in about May 2009. She said she would attempt to get submissions to the Department by the end of February 2009.

6. On 19 March 2009 the Senate Committee delivered its report in relation to the Exposure Draft. The key recommendations were that the Exposure Draft be simplified in language, structure and terminology, that there be greater adherence to overseas models and that the proposed date for the commencement of the scheme, May 2010, be extended for 12 months to May 2011.

7. The following submissions have been prepared by Maryanne Loughnan, Peter Fox, Anton Trichardt, David Turner, Jonathon Redwood and Lana Collaris ("the Authors").

Exposure Draft - General Observations

8. The Authors are of the view that the Exposure Draft has not been drafted in a way that best facilitates the understanding by lawyers of the intention of the legislature. It is appreciated that it addresses some of the most arcane principles of personal property security law, however, the tenor of the submissions to the Senate Inquiry make out a strong case that:

   (a) the best model has not been adopted;

   (b) the drafters have sought to create an original model which is counter-productive;

   (c) drafting in line with other international models which would have permitted the Australian courts to have recourse to many years of judicial learning has not been availed of;

   (d) unnecessary terminology has been adopted to describe the primary concepts;

   (e) too many hands, in the form of stakeholders, are essaying the task;

(f) stakeholders do not have the resources or authority to do the work necessary to approach the task other than reactively;

(g) the resultant effect is a patchwork of conflicting ideas and policy choices rather than a seamless whole.

9. The significance of embracing a model which dovetails as smoothly as circumstances would allow with other PPS regimes and which comprehends an opportunity to enable ready resort to jurisprudence laboriously shaped in forums sympathetic to local customs was clearly stated in the responses of the VicBar May 2007 Submissions and the VicBar June 2007 Submissions.

10. The Authors refer in particular to the material provided to the Senate Standing Committee for Legal and Constitutional Affairs by Professor Anthony Duggan in the form of submissions dated 5 December 2008 and his evidence before the Committee on 23 January 2009.

11. The Authors recognize that Professor Duggan is probably the leading academic on this topic with the most in-depth knowledge of the Australian system as well as the Canadian and New Zealand systems. He has taught in this area of the law in Australia for a number of years before moving to the University of Toronto where he teaches Canadian personal property security law, is a co-author of a leading textbook on the area and has published widely on the topic. He has also taught in New Zealand. Rightly, he could perhaps be regarded as the pre-eminent authority in this area of legislative reform in Australia. Professor Duggan's statements, for the purpose of considering and adopting an appropriate model, and the difficulties that the proposed model will engender should be considered with deep respect for his wide-ranging experience and knowledge of current PPS regimes.

12. When compared with existing PPS regimes, Professor Duggan has identified only one superior outcome in the proposed model, namely, that it provides for uniform laws in each State and Territory and a single register1. In all other respects he takes the view that the Exposure Draft may be criticised for being unnecessarily complex, containing errors and adopting questionable policy choices2.

13. Professor Duggan has been the most articulate in expressing his concerns regarding the Exposure Draft because he has the experience of this complex area of law to support his deep sense of unease. Other stakeholders' views range from

[1] General Comments p 2
[2] General comments p 3

guarded general support to forthright disapproval which would appear to stem from one source: that by reason of the paradigm shift in approach to personal property security, its sheer complexity, errors and policy choices there is a general failure to readily grasp the reach of the model. In our view, those responses indicate a stark warning of the likely impact the Exposure Draft will have if implemented without a further intensive review process which we outline below.

14. Professor Duggan commented in relation to the scope of the exercise of considering the Exposure Draft as follows:

> *"... It is important to stress that the following discussion is a selective one. I cannot claim to have undertaken a comprehensive review of the legislation. A comprehensive review of the legislation would require careful comparison of the Bill with the New Zealand and Canadian PPSA's and as indicated above, it would involve asking the following questions of each provision: (1) is there a corresponding provision in the other jurisdictions and, if so, is the wording the same? (2) If the wording is different, is the meaning the same? (3) If the meaning is different, was this an intended or unintended consequence and is it justifiable? This kind of analysis would take months and far more resources than are available to me, and, I suspect most stakeholders.*[3]

15. Professor Duggan also stated in his evidence:

> *"... if it were me I would say yes, start again. I understand the difficulties of doing that. But it is a question of going ahead now with this product for the sake of getting in quickly or taking a little bit of extra time, maybe going back to the drawing board, to get it right,. I think in the longer term interest of everybody it is better to do the latter. What can I say of other people's view? I have glanced quickly through most of the written versions of the submissions that you have received. Very few of them come to grips with the legislation overall.* [4]

16. In the May VicBar 2007 Submissions the need for harmonisation with international codes was emphasised:

> *The overriding consideration of the proposed scheme ought to be that it operates in unison to the fullest extent practicable with the schemes of foreign jurisdictions. This provides for a more ready understanding by the credit provider, wherever located, as to the value and quality of the interest in the property being offered as security. Such an outcome is likely to enable cheaper costs in providing credit and facilitating competition by encouraging more sources of credit, including ready sources of foreign funds.*
>
> *Therefore unless there is some prevailing impediment or unfairness that arises by reason of the operation of local factors the Australian scheme should reflect as closely as possible that*

[3] General Comments p 5 - 6
[4] Transcript p 5

> *of the most influential of world economies, namely, the US. It is likely that, as other jurisdictions adopt the scheme, the US model will be the template. If the US scheme, as provided by the Uniform Commercial Code – Secured Transactions ("UCC"), is treated as the starting point, these fresh regimes will always have a large overlay of commonality. The basic tenets of the introduction of the scheme will not be lost sight of: that is, to enable cheaper credit to be on offer as a result of reduced costs, less risk and more competition.*
>
> *If the schemes of various jurisdictions become too individualized there is a danger that the costs of interpreting and adapting to a particular scheme results in no costs savings nor increased competition, or worse, added costs, more uncertainty and less activity in the market.*[5]

17. The Exposure Draft appears to take a different approach to that adopted by New Zealand – the New Zealand Act is primarily based on the Saskatchewan model and incorporates cross-referencing of sections taken from that model as well as other Canadian models. In his submissions to the Senate Standing Committee Professor Duggan stated:

> *".. The Saskatchewan PPSA is a tried and tested model. It is the product of lengthy and careful deliberations by leading commercial lawyers and it has stood the test of time. The Saskatchewan PPSA, in turn, is based on Article 9 [of the United States Uniform Commercial Code] which itself was the product of an exhaustive drafting process involving some of the finest minds in United States commercial law. Close adherence to the North American model makes sense, because it enables the local lawmaker to free-ride on Canadian and United States learning and experience. By contrast, departure from the model creates uncertainty and increases the risk of error. These concerns are exacerbated if the drafting is done under time constraints and without access to the kind of expertise the Canadians and Americans had at their disposal when drafting their laws."*[6]

18. The Authors respectfully concur with the views of Professor Duggan in relation to the Exposure Draft. We make the following points in recommending that extraordinary caution should be exercised in relation to the proposed reform:

    - Once a PPSA model comes into force the whole of Australia's credit industry for the finance of goods and other personal property will be governed by such legislation;

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[5] Paras 3 to 4
[6] Page 3

- The legislation will determine most of the fundamental rights as between the financier and the debtor in respect of many millions of financing and purchase arrangements;
- It will overlay centuries of meticulous judicial reasoning which identified a myriad of security interests in goods and other personal property;
- The reform will be experimented largely on Australia's four major banks which will bear the initial cost of :
  - drafting agreements that adequately protect their security interest and are compatible with all applicable statutes;
  - educating sales personnel regarding the changes;
  - implementing systems that are compatible with the national register;
- By reason of most disputes relating to priorities and interpretation of the legislation generally starting off as simple debt collection or *Corporations Act* matters, litigation will occur mainly in, and occupy the scarce resources of, the courts of the various States;
- The cost of interpreting the legislation will be borne by the banks on the one hand and those debtors who have the misfortune to be caught in a dispute in the years immediately following its implementation – this has the consequence of privatising the cost of effective drafting;
- The register has the potential to be a readily accessible inventory of an individual's primary assets thereby possibly bringing into play some significant privacy issues.

19. Taking into account the gravity of these matters and the current responses to the Exposure Draft it is unlikely that the end-users of this reform will have the confidence in its efficacy that the nature of the reform requires.

20. Having regard to the complexity, prolixity and obscurity of the Exposure Draft, one should also be concerned about section 190 which provides prescriptively for the registration of personal property as collateral if a person believes on reasonable grounds that a security interest in the property is or will be held by a person, not necessarily the applicant. Bearing in mind that lay persons will also be dealing with the Exposure Draft to register security interests, one wonders how they, in particular, will be able to ascertain on reasonable grounds that they are dealing with an interest or right that is in substance a security interest. The situation is not improved by section 235 which requires a person to exercise his

or her rights "honestly" and in a "commercially reasonably manner". Making the wrong decision about registration may have serious consequences - wrong registration could lead to sanctions and damages, while non-registration leads to a loss of priority and casts doubt over enforceability generally.

Conclusion

21. The Authors conclude that much valuable work has been done to date in creating a highly original model in the Exposure Draft and obtaining stakeholders' responses. There should be no embarrassment in taking a step back from the current process of reform and absorb the messages that many learned individuals have contributed.

22. It may be helpful to digress here and recall the history of Torrens system land reform. The first enactment of the scheme came into force in South Australia as the *Real Property Act* on 2 July 1858. The concept had first been mooted in 1829 and later by the British Real Property Commissions of the 1830s. Sir Robert Torrens was no lawyer, but driven instead as a businessman (described on one occasion in the press as a "land-shark") to use his political authority and powerful personality to find a solution to the shambles that was real property title in the new State of South Australia. The State had arisen out of its purposeful colonisation as a "land-job". The frenzied staking of claims over a period of some 25 years resulted in abysmal surveying, rotten title keeping and multiple sales of holdings by the same vendor. The first form of the *Real Property Act* was described thus, *"[t]he general impression created by the language of Part XIV is that the draftsman had reached a stage at which he was anxious to see the end of a difficult task".* The Act required major overhauls for 30 years after its first enactment[7].

> *"Torrens saw things in straightforward terms – the stroke of the broad brush. As Jessup remarked he had 'the rough hand of the lay reformer' and 'tinkered with a subject that abounded with intricate problems, and the lawyers saw the possibilities'. And it was those problems that led to amending Act after amending Act in the 30 years following the introduction of the first bill. Two years after his death the SA legislature passed the Real Property Act 1886. In some respects Torrens would hardly have recognised it.*[8]

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[7] Professor Rosalind Croucher *"150 years of Torrens – Too much, too little, too soon, too late?"* (2009) 31 Australian Bar Review 245

[8] Ibid, p 260

23. The Authors note the submissions to the Senate Standing Committee of one of our number, David Turner, in which he made the point that presently the national scene provides very good security solutions with a high degree of certainty, very unlike the scene in South Australia for land law in 1858. If a poor model for reform is visited on the financial sector in the first instance, the lawyers will see the possibilities for raising drafting issues in a dispute, and the sorely tested participants will be unforgiving and vocal. In short there will be very little latitude in which to experiment in the public domain.

24. The Authors consider it is now an appropriate time for a small team of the most expert persons available in this area (hopefully this would be led by Professor Duggan and also include Professor Philip Wood, arguably the world's leading academic on comparative financial law) to be retained by Government to produce a model in bill form that can then be introduced into Parliament without further consultation of stakeholders. We would anticipate that the team use the New Zealand *Personal Properties Securities Act 1999* as a basis for the Australian legislation. It is to be noted that a number of mistakes exist in the New Zealand Act and there have also been notable omissions. The New Zealand legislation appears not to be as up to date as the Saskatchewan legislation. So too, the Canadian statutes have not yet kept up with *Revised Article 9 (*2001) which deals with perfection by control of accounts and investment securities, etc. Also, case law in New Zealand has posed some problems, for example, in *Waller v New Zealand Bloodstock Ltd*[9] in the context of leasing. It is critical that a team of experts look closely at the New Zealand Act, the Saskatchewan Act and *Revised Article 9* and that any necessary modifications take into account certain policy choices that best fit the Australian financial environment.

25. In our view Australia does not need legislation that is not an improvement on the present system and that is not simple to understand, comply with and is overall workable. Sir Roy Goode QC makes the point that the great achievement of American commercial law was the Uniform Commercial Code. He has said that two factors underpinned the power of the UCC. First, the determination to achieve a broad uniformity of commercial law across the US and secondly, the urge to modernise, improve and simplify the law and give it a coherent structure[10]. Unless the second of Sir Roy Goode's goals is achieved reform has no worthwhile purpose.

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[9] [2006] 3 NZLR 629
[10] "*Removing the Obstacles to Commercial Law Reform"* 123 LQR 602 at 611

Specific Matters Regarding the Exposure Draft

Definitions

Security Interest and securitisation

26. The definition of security interest is particularly broad. Subsections 28(2)(j) and 28(3)(a) relate to assignments and sales and when taken with use the words "in substance" in subsection 28(1) and the economic equivalence overlay, will undoubtedly extend to securitisation transactions, some of which involve an outright sale of accounts and chattel paper. The securitisation market in Australia is different to that of the US. Whether the Australian financial market needs to adopt these provisions should be carefully analysed by comparison with the current US position. The policy behind the Article 9 inclusion of sales is the view that the distinction between a security transfer and a sale is blurred, that is, it is difficult to ascertain whether the transaction is intended as security or not.

27. The policy choice is between having no means of notifying assignments by true sale of interests in securitisation assets and having them included in the registration system because the alternative is, or continues to be, unworkable.

28. The first choice which posits the international focus of securitisation is not a sound policy choice to include transactions that are truly sales lest it create unnecessary confusion and mislead persons making inquiry of the Register. It is not that long ago that Victoria repealed Part IX of the *Instruments Act* which required the registration of assignments of book debts (accounts) by way of security or absolutely.

29. The latter choice is similar to the Victorian treatment of book debts under the *Companies Act* 1961. Transactions under Part IX of the *Instruments Act* were registrable as charges under the *Companies Act* 1961 in Victoria whether they were in the nature of charge or outright sale. There was otherwise no way of notifying a future dealer or debtors except by notice and in the course of inquiry. Including true sales in the PPS model with provision for deemed registration may be beneficial when compared with the fragile nature of factored book debts at law.

"In substance" approach to determining the nature of an interest in personal property

30. The definition of "security interest" in section 28 provides that it means "an interest or right in relation to personal property provided for by a transaction that *in*

substance secures payment of performance of an obligation (without regard to the form of the transaction or the identity of the person who has title to the property)".

31. This is a functional approach and corresponds with the approach to determine whether an interest in property is a "security" by the High Court in, for example, *Handevel Pty Ltd v Comptroller of Stamps (Vic)*[11], and accepted in *General Motors Acceptance Corporation Australia v Southbank Traders Pty Ltd*[12]. As such the definition is not objectionable, but the use of the words "in substance" may prove to be problematic. Those words do not exist in Article 9. These words do appear in the Canadian statutes, notably Saskatchewan - section 3(1) and Ontario - section 2. There it is stated the statute "applies to every transaction without regard to its form and without regard . . . that in substance. . . ". The words themselves to do not appear in the definition of a security interest. The New Zealand drafting style is different hence the inclusion in the definition of security interest. It would seem that the use of the words "in substance" is to differentiate between true security interests and those that are in an economic sense security interests such as title retention devices, including leases.

32. As a policy matter, the Commentary to the Exposure Draft expresses the view that the deeming of various interests as security interests is based on its adoption of the false wealth doctrine. This doctrine, widely adopted in Napoleonic jurisdictions and the basis for not recognising the split in equitable and legal ownership effected by common law trust, has been discredited by Professor Philip Wood. Modern commercial arrangements that have hitherto not been re-characterised by courts as security interests would on the expansive definition in the Exposure Draft constitute security interests. The traditional Anglo-Australian approach has been to determine the character of a transaction by reference to its legal nature, not its economic effect[13]. In other words, courts have generally respected the legal form intended by the parties as evidenced by the language they actually used in the contractual agreement. The case of *Beaconswood Securities Pty Ltd v ANZ*[14] is an important recent example. A proceeds clause of the type considered by the High Court in *Associated Alloys Pty Ltd v ACN*[15] to

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[11] (1985) 157 CLR 177 at 196

[12] (2007) 227 CLR 305 at [20]

[13] It is noted, however, that the High Court in *General Motors v Southbank Traders* (2007) 227 CLR 305 took a broad approach to the interpretation of "secured payment of a debt" so as to pick up a retention of ownership clause.

[14] [2008] FCA 594

not to be a charge, could be considered a security interest under the substance over form approach.

33. The Authors are of the view that trust arrangements of the type identified in the *Associated Alloys Case* should be excluded from the interests caught by the Act. It is inconsistent with the notion of the debtor or grantor being empowered to grant a security interest by reason of being the beneficial owner of property. The Authors consider that a trust arising out of retention of title clauses is stretching "in substance" too far. As a matter of policy the Act should confine its operation to transactions where the debtor has beneficial ownership or has an opportunity under the security agreement to acquire it.

Control of Controllable Property

34. The Authors are concerned regarding the notion of "control", which is introduced in Division 4 of Part 1.3, as a method of perfection.

35. Notice filing is a key principle of Article 9. The 2001 revision has introduced a third method of perfection by control. This change was made in the context of legislation dealing with primarily investment securities transfers. Canada has the *Securities Transfer Act* to inform parties with some certainty when securities are transferred and their rights in respect of them. Despite this, we understand that the Canadian provinces have resisted moving to control as a third form of perfection because of the conflict with the principle method of perfection by notice filing. This publication principle is a central tenant of Article 9.

36. New Zealand has not added control as a method of perfection but its legislation predates the Article 9 2001 revision. The Authors believe that Australia should consider very carefully whether it should adopt control as a third method of perfection.

37. Notwithstanding that a set off is excluded as a security interest under section 6 of the Exposure Draft, where a bank has a general security interest such as a debenture charge, combined with its right of set off, the ADI of the grantor customer will fall within the terms of section 46 of the Exposure Draft to perfect a security interest in respect of the ADI. This is the result of providing that a secured party has control of an ADI account if the secured party is able to direct disposition of the funds from the account without further consent by the grantor. If control is to be maintained as a method of perfection the right to set-off or

combine accounts as a form of control should be specifically excluded from the Exposure Draft.

Tangible property

38. Section 138, like other provisions in the Exposure Draft, uses the term "tangible property", and not the term "goods" which is used in other PPS Acts and Article 9. In order to understand what "tangible property" means, one has to go to section 26 (Part 1.3 – Interpretation, Division 1 – Definitions) where the term is defined as including crops, livestock, trees that are personal property, wool, minerals that are personal property, satellites and other space objects, but excluding chattel paper, a document of title, an investment instrument, an investment entitlement, currency and a negotiable instrument.

39. The obscurity of the term is exacerbated by the inclusions and exclusions in the definition that are also defined, for example:

    (a) "chattel paper", is a term unknown to the common law. It is limited by its application to US law without any relevant basis in Australian law, is defined in section 26 by reference to the meaning given to the term by section 36. Chattel paper under Article 9 encompasses chattel mortgages, goods leases, and hire purchase arrangements;

    (b) "personal property" is defined in section 26;

    (c) "investment instrument" is defined in section 26 by reference to the meaning given to the term by section 39, which in turn refers to the *Corporations Act* 2001;

    (d) "negotiable instrument" is defined in section 26 by reference to the meaning given to the term by section 41 which in turn refers to the *Bills of Exchange Act* 1909.

40. Although the definition of "tangible property" does not refer to "intangible property", the section 26 definition of that term excludes "tangible property".

41. Section 138 contains further defined terms which have to be understood to make sense of the provision, for example –

    (a) "commingled' which is defined in section 26;

    (b) "security interest" which is defined in section 26 by reference to the meaning given to the term by section 28 which in turn contains various

defined terms: see the comments in relation to the "in substance" approach in paragraphs 30 to 33 above.

42. Section 50 deals with "charges and fixed and floating charges". Subsection 50(3) provides that a "reference to a charge over property is taken to be a reference to a security interest that has attached to: (a) a circulating asset; or (b) personal property that is not a circulating asset." Subsection (4) further provides that a "reference to a floating charge over property is taken to be a reference to a security interest that has attached to a circulating asset." Reference has already been made to the term "security interest", but one has to go to section 26 to find a definition of "circulating asset", merely to be referred to section 51. The definition also appears to be more concerned with the term "current asset". If the intention is to preserve the existing priority for preferential creditors in a winding up, then the Authors believe this can be achieved in a more direct way in the *Corporations Act.*

43. Section 51 contains the term "grantor" (and not debtor) that is used throughout the Exposure Draft. It is widely defined in section 26 to mean, amongst other things, *any* person who has *an* interest (or right) in personal property to which a security interest is *attached*. The definition seems to include persons who are not party to the security interest.

The Case for the Floating Charge

44. It is worthwhile at this point to consider the case for the recognition of a floating charge in the PPS regime.

45. The *Commentary, May 2008* states that other jurisdictions have abandoned the concepts of "fixed" and "floating" charges because they are out of keeping with the functional approach to secured transactions. It is thought that the model should be premised on the notion that a security interest in personal property arises where property is used to secure payment or the performance of an obligation regardless of the legal form of the obligation[16].

46. The Authors do not agree with this approach in relation to the floating charge. Recognition of the floating charge in the proposed Act is a policy choice, that is, the functionality of the scheme is not impaired whether it is provided for or not.

[16] PPS Bill 20008 Commentary, May 2008 para.11.96

47. As a policy matter it appears the issues to consider are:

    (a) harmonisation with other PPS regimes;

    (b) the level of expectation of the main suppliers in the finance industry that the *Corporations Act* regime will survive the reform;

    (c) general efficacy of the floating charge, in other words, is it a good or bad thing in terms of providing effective security.

48. In support of its incorporation it is contended that there are many good reasons not to abandon the floating charge:

    (a) the Exposure Draft already provides for a floating lien over inventory and receivables. Not much more is required to develop these provisions to provide for the floating charge;

    (b) although the floating charge has not been recognized in other PPS regimes that is largely because it never gained a foothold in US common law. Interestingly in the US the development of the floating lien has filled this gap[17]. Professor Wood is of the view that Article 9 is outdated in this regard and that the fixed and floating charges system is a better system[18];

    (c) this form of security provides added flexibility when structuring finance;

    (d) it is part and parcel of the appointment of a receiver to the undertaking of a corporation;

    (e) the operation of the floating charge is in sharp contrast to the proposed process under section 109 of the Exposure Draft which provides for the priority of a purchase money security interest in inventory over prior registered interests upon notice before the inventory is acquired by the grantor. A floating chargee is, as a matter of course, postponed to the secured interest of a financer of the purchase of goods, notice or not. There ought not be such onerous conditions imposed on the holder of a purchase money security interest.

49. The argument against the incorporation of the floating charge into the Australian model is that its inclusion will not be in keeping with the approach of other PPS

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[17] UCCC Article 9-205

[18] Professor Philip Wood,'' International Approaches to Security Interests"', paper presented at the 25th Annual Banking and Financial Services Law & Practice Conference 25-26 July, 2008

regimes. It has not been incorporated in the current Canadian or New Zealand regimes. The Canadians tried it and found it wanting.

50. The Exposure Draft itself confers a floating lien on inventory and receivables and it is but a short step from there to make provision for floating charges at large. There does not appear to be any reason why the model should give a secured creditor the right to obtain security in specie in all future property (subject to attachment and perfection) and then shut out future advances by giving that security taker first position. It is wrong in principle and it is unnecessary. The only in principle steps involved in recognising the floating charge are - to deal with the hovering nature of the interest as if it were an interest in specie in praesenti for existing property and on coming into existence of future property, to provide for the consequences of priority and consequential matter by reference to the categories of property which it covers, and to acknowledge the floating charge is usually accompanied by a negative covenant against dealing with floating charge property by way of security or the whole or a substantial part of it. The Exposure Draft has a confused mixture of provisions for the creation of a security by way of floating charge, but then operating in another schema by reason of the consequences which that kind of charge produces rather than, or as well as, the statutory outcomes.

51. A holder of a floating lien may not want to deal with property as an agent, especially as regards interests which impose obligations on a mortgagee in possession. There are also practical problems - a floating charge may be allowed under a joint venture agreement but a fixed security is not. A floating charge may cover property moving in and out of Australia. A floating charge may always be perfected by further assurance by way of fixed security. There appears to be no operating principles which make the floating charge incompatible.

52. The general comments in the VicBar submissions of October 2008 on the Regulations regarding fixed and floating charges have largely been adopted in the Exposure Draft. Sections 85, 86, 87, 88, 92 and 93 do not apply unless the transaction is by purchase or lease, in other words, the priority provisions are limited to cases of purchase or lease and usually do not apply as between competing security takers.

53. The Exposure Draft, however, does not protect the present priority of a floating charge holder who relies on a registered negative covenant on future dealing with floating charge property to maintain priority over a subsequent security taker.

There is no provision for registering the restriction. There is no provision for registering the complete security agreement which contains the restriction.

54. The Exposure Draft deals with negative pledge clauses in section 124[19]. There is room for different understandings of what is meant by a "negative pledge". The one the subject of the comment in the previous paragraph is a negative covenant which restricts dealing in floating charge property. Section 124 seems to be dealing with a different point, that is giving efficacy to a transfer which is otherwise defeated because the restriction renders the property inherently non-assignable (albeit still transmissible?). The 'springing lien' solution has never found favour in Australia. The protection to be afforded by a negative covenant allied with a floating charge which restricts further dealing with respect to floating charge property provides a mid-point between security takers in the position of the first security party taking everything and the second security party getting nothing. It is also meant to operate as a qualification to the dealing in the ordinary course of business context, should that apply as between competing security takers.

55. Section 89 (regarding currency) requires the transferee not to have knowledge of the security interest. Sections 90 and 91 contemplate dealings in investment instruments or investment entitlements and preserve a security interest where the transferee has knowledge that the dealing would constitute a breach of a security agreement, however there is no mechanism to put a person on notice about the terms of a security agreement. There is no reason to leave these matters to the general law if the new regime and the register could resolve them with a minimum of input.

Part 2.3 Acquiring Personal Property Free of Security Interest

56. Generally Division 1 of Part 2.3 now appears satisfactory in so far as its operation is limited to regulating the priority of a purchase money security interest although in practice it will require constant interpretation. Its terms, however, are broader than those found in Article 9 and the Canadian and New Zealand statutes and the drafting should be narrowed in keeping with those statutes.

57. Division 2 of Part 2.3 contains other provisions relating to acquiring personal property free of security interests. Section 99 may cause concern. It provides that where a person acquires tangible property free of a security interest because of

[19] cf NZPPSA section 87

the operation of an extinguishment provision, then the transferee also acquires any intellectual property or intellectual property licence relating to the tangible property free of any security interest that is taken to have been granted in the intellectual property or licence. We believe that the PPS should deal with priority issues in relation to registered security interests rather than the relevant legislation such as the *Patents Act*. Despite this we believe that these matters will require detailed examination to determine whether the balance is right.

Part 2.4 Priority Between Security Interests

58. If the floating charge as understood at general law is to be given recognition in the Australian PPS model, these provisions do not appear to give priority to a floating chargee who relies on a negative pledge on dealings with floating charge property and who would have priority under the *Corporations Act*. Except for controllable property, priority will be regulated pursuant to subsections 100(5) and (6). These are not as sophisticated as those provisions of the *Corporations Act* which provide for regulating priority between different chargees of the same property.

59. *Residual priority rule:* sections 100 and 101 deal with priority between intervening security interests and are overly complex. Section 101 should be replaced with a provision that determines the priority of later unregistered security interests in respect of the same collateral in accordance with the order of attachment as is the case in the New Zealand Act, section 66[20]. The Authors do not understand how subsection 100(4) can ever apply as it is difficult to see how two or more competing security holders can control the same collateral. One controls and the other does not. We think that the reference to priority time is also a complicating factor because if the competition is between two registered interests, the first in time prevails unless a different policy choice can be demonstrated as appropriate.

60. Section 107, which gives priority in respect of all future advances, is a very small section but may have very large consequences. In practice, the present law does not give priority for further advances unless there is an obligation to make the further advance (and very rarely is there such an unqualified obligation). Section 107 reverses this position and may prove wholly unsatisfactory in declining economic conditions where borrowers need to obtain further finance. Section 107 would prevent a subsequent lender from obtaining priority with respect to present

[20] cf section 35 Saskatchewan Act

property even though the present lender is unwilling itself to make further advances. The prospect of such further advances and the priority afforded by section 107 may be sufficient to discourage new lenders. Section 107 advantages existing lenders. It is acknowledged that except in the case of a purchase money security interest, a later lender must deal with the prior holder of a security interest before funding. The proposed position is not necessarily a good policy choice for Australia. It may produce anticompetitive effects in a market dominated by four main banks. It does not have the advantage of prior ranking of new money lent into a bankruptcy against the unsecured assets available in the bankruptcy.

61. Division 3 deals with priority of purchase money security interests. Section 109 deals with inventory. The procedure in relation to inventory is that a purchase money security interest will have priority if the prospective security interest holder has registered a security interest and gives notice to other persons who have a security agreement which describes the inventory, in effect, before the inventory is acquired by the grantor. This is a cumbersome procedure. The policy choice being made is to favour old money applied to inventory which has been sold and the proceeds spent over new money applied to purchase the new inventory concerned. A good policy choice would provide for the new purchase money security interest to have priority without notice.

62. The Authors understand that the requirement for notice to prior holders of a security interest whose security interest covers after-acquired property and includes inventory is to ensure that they do not make advances relying on new inventory in making fresh advances. The New Zealand Act does not require notice - section 74. Australia should follow the New Zealand approach in section 74 modelled on Saskatchewan's old section 34(3). If the approach is to require notification to prior secured parties as is now the case in all Canadian jurisdictions then the filing statement should provide an address for service of such notices.

63. Section 110 deals with non-inventory purchase money security interests. Registration is required within five days after the grantor obtains possession of the property. This should be extended to 10 or 15 days as is the case in New Zealand and Canada, respectively. We note that Ontario is the only Canadian province with a 10 day period. There is a defect in the requirement for possession as the commencing point for notice. When will that be? How will it be recorded? Why

cannot another reference be the point where title is obtained? If different the time should commence at the earlier in time of the two reference points.

64. Fixing relative priority of interests by reference to whether a subsequent dealing is "in the ordinary course of business" of a company is problematic. Section 51 is confusing. If it is intended to preserve the current priority of creditors with respect to the floating charge property, by tinkering with assets typically subject to the floating charge such as inventory and book debts, then this should be dealt with in the *Corporations Act* not in the PPSA What the "ordinary course of business" is depends on the nature of a particular company's business. There is old authority on this. Generally, the "ordinary course of business" includes sales, leases, mortgages, charges, payment of debts, discharge of liabilities, and other transactions with a view to carrying on the concern: see *Willmott v London Celluloid Co.*,[21]; *Government Stock Co v Manila Rail Co.*,[22]; *Hubbard v Hubbard & Co.*[23]. The editors of *Palmer's Company Law* [24] note that because the objects of a company are to be taken into account in determining the ordinary course of business of a company, if the objects authorise a sale of the company's undertaking or portion of its undertaking, that prima facie will be in the ordinary course of business of the company.

65. Applying such a broad concept to securities in personal property may produce unintended consequences in two ways. First, to restrict the notion of the ordinary course of business generally, will prevent companies obtaining subsequent finance by granting security over their personal property. Secondly, to maintain the notion of "ordinary course of business" without allowing for the intermediate position achieved by distinguishing property charged by way of fixed charge and property charged by way of floating charge may have a chilling effect on the provision of subsequent finance which otherwise might have been available on the faith of a specific mortgage or fixed charge. A mortgage of equipment may be in the ordinary course of business. A lease of property may be in the ordinary course of business. A sale of the undertaking may be in the ordinary course of business. A sale of inventory might not be in the ordinary course of business in some contexts. A mortgage or sale in breach of a contractual restriction might be in the ordinary course of business depending on the circumstances. These results flow from the breadth of the concept when considered in all the

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[21] 34 C.D. 147
[22] (1897) AC 81
[23] 68 L.J. Ch 54
[24] Ninth Edition, Part III on Debentures (1903, Stevens)

circumstances. How will it have a narrow application in the Exposure Draft if there is no specific narrowing content given to it for example, by specifying that certain matters exclude dealings as being in the ordinary course of business?

Commingling

66. Part 3.3 deals with "Commingling" or commingled property, that is where goods have become part of a product or mass and have lost their original identity in the product or mass - for example, where ingredients are used to make processed food, such as flour and yeast to make bread.

67. Part 3.3 consists of sections 138 to 140, while sections 141 to 143 (Part 3.4) deal with general provisions on priority and enforcement pertaining to commingling. In this regard, compared to, for example, section 37 of the Ontario Act which succinctly provides as follows:

> *"A perfected security interest in goods that subsequently become part of a product or mass continues in the product or mass if the goods are so manufactured, processed, assembled or commingled that their identity is lost in the product or mass, and, if more than one security interest attaches to the product or mass, the security interests rank equally according to the ratio that the cost of the goods to which each interest originally attaches bears to the cost of the total product or mass".*

The Exposure Draft provisions are prolix, and appear to overlap with the concept of "accession" as defined in section 26 read with section 34.

Enforcement and Remedies

68. The notice provisions should follow Article 9 and the New Zealand Act. Specifically, section 168(2) should provide for at least 10 business days - 5 business days is too short. Ontario provides 15 days while the other Canadian Acts allow a 20-day notice period as per section 59(6) of the Saskatchewan Act.

69. The contracting out provisions in section 154 and following should be subject to an overriding standard of not being "manifestly unreasonable". This is the approach in Article 9-603(a). This more appropriately balances party autonomy and freedom of contract with minimum standards of commercial fairness.

Contractual Restrictions on Transfer of Accounts and Chattel Paper

70. Section 126(2) follows Article 9-406. It should, however, also include the language with respect to notice to the account debtor contained in that section.

Effect of failure to Perfect Security Interest

71. Other than on priorities, it is unclear what the effect is of failing to perfect a security. In other words, does failure to register or otherwise perfect render the security invalid or void in liquidation against the liquidator or administrator? Clearly that ought not to be the position if it is not already clearly embodied into the legislation. In New Zealand an unperfected security interest is valid. As Professor Wood and others have observed, there is no sound policy justification for compulsory registration for a security interest to be effective or effective against parties other than the grantor and secured party[25].

Specific Drafting Issues

72. Section 63(3) contemplates that the security agreement must be "signed by the grantor" and a comprehensive definition of "signed" is given, however there appears to be no provision for signature by an agent or attorney, again ignoring the experience that such provision must be made or the Act will be interpreted to require personal signature. Surprisingly the Exposure Draft, which has at its heart the registration of security interests, provides in section 64 that a security interest "in particular collateral is perfected if: (a) the security interest is attached to the collateral, and subsection (2) applies." Perfection occurs by registration which is provided for in section 189, which section refers to 'registration … of personal property as collateral". The curious aspect is that it appears that registration of the collateral is the focus and not the security interest.

73. Section 161 provides that prior to seizure of tangible property no notice has to be given to the grantor. The grantor only has to be in default of the security agreement. No notice of default appears to be provided for. It is noted that if the security agreement is governed by the *Consumer Credit Code*, a notice would have to be given under section 80 as a precondition. This section enables a combined notice to be given for the purposes of the *Consumer Credit Code* and also the *Property Law Act*. Under section103 of the *Property Law Act 1958 (Vic)* notice must be given. The legislation should deal with the issue otherwise notice will need to be given under one or both of the other Acts.

74. Further, it is noted that no notice must be given to other secured parties prior to seizure. Section 165 deals with "seizure by higher priority parties – notice", but

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[25] See Wappett, "Personal Property Securities" in Australian Financial Law (Mallesons, 5th ed), p 500.

they must first become aware that an enforcing party has seized the collateral. Higher priority parties should be given notice.

75. Under subsections 168(3) and (4), the notice of disposal must be given at least 5 business days before the day the collateral is disposed of. However, subsection 168 (3)(c) states that the notice must state that the secured party proposes to dispose of the collateral unless an obligation is performed or an amount is paid at least 10 business days after the notice is given. Therefore performance of the obligation or payment could occur *after* disposal. It is noted also that it is unnecessary to telegraph to other security parties one's intention to exercise one's power of sale. There is also the practical problem, why would a lesser security party give notice and take enforcement action if there is insufficient value in the collateral to cover the exposure that the later security party has to the debtor?

76. In relation to subsection 174(2), what if the debt owed to the secured party is less than the value of the collateral? In a surplus do the secured parties with a lower priority still lose their security interest? Does the grantor lose the right to the surplus? The retaining party could have quite a windfall which is contrary to some very basic principles at law. How is notice given? What if a security holder does not receive a notice (for example, lost in mail) – do they lose their security?

77. Under subsection 180(3) the right to redeem should extend to the grantor and not just the debtor. The word "debtor" only makes sense if the term "grantor" is removed.

78. The right of reinstatement in section 181 should be limited to the debtor. Also it should be limited to security agreements entered into after the commencement of the legislation. It is to be noted that there is a right to reinstate a *Credit Code* contract (section 94) as well as restriction on sale in the case of the goods mortgage (section 83). The provisions in the Exposure Draft should be made consistent with those rights.

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