Attorney-General's Department

Response to submission by Allens Arthur Robinson, Blake Dawson, Freehills, Mallesons Stephen Jaques

This paper comments on the further issues raised in Part 2.2 of the submission by Allens Arthur Robinson, Blake Dawson, Freehills, and Mallesons Stephen Jaques.

Consumer property

Clause 10 of the Bill defines 'consumer property' as follows:

> ***consumer property*** means personal property held by an individual, other than personal property held in the course or furtherance, to any degree, of carrying on an enterprise to which an ABN has been allocated.

The effect is that if property is held by an individual in the course of an enterprise that does not have an ABN, the property would be consumer property.

The Bill would treat collateral as consumer property if the property is held by an individual whose principal place of residence is in Australia, in the course of an enterprise carried on outside Australia, that does not have an ABN.

It would be possible to address this special case by amending the Bill to provide that consumer property includes property that:

(a) is held by an individual whose principal place of residence is in Australia;

(b) is held predominantly for personal, domestic of household purposes;

(c) is located outside Australia;

(d) the transaction is governed by Australian law (despite the property being located outside Australia); and

(e) is not held the course or furtherance, to any degree, of carrying on an enterprise to which an ABN has been allocated.

The Department considers that these are unusual circumstances, and that an individual resident in Australia who is borrowing on a secured basis against the personal assets held overseas would most likely hold those assets in a corporation rather than personally, or that the transaction would be governed by the law of the place where the property is located. Amending the Bill to address these circumstances would appear to introduce an unnecessary complication in response to a technically possible (but unlikely) scenario.

Intellectual property

The existing definition provides a bright line boundary by requiring that the Commonwealth must have legislated with respect to a right before it can be counted as intellectual property.

While this proposition is attractive in-principle, it would be difficult to define all of the chose in action that ought to be counted as intellectual property. Any attempt to extend the definition would present considerable difficulty in determining which rights should be counted as intellectual property and then in precisely defining the rights that are to be counted as intellectual property.

Clause 77 Priority of unregistered foreign security interests

Clause 77 is based on section 32 of the New Zealand PPS Act, which provides as follows:

> **32 Position where no public record, etc, of perfection of security interest**
>
> (1) If the law governing the perfection of a security interest referred to in section 30 or section 31 does not provide for public registration or recording of the security interest or a notice relating to it, and the collateral is not in the possession of the secured party, the security interest is subordinate to:
>
> (a) an interest in an account receivable that is payable in New Zealand; or
>
> (b) an interest in goods, an investment security, a negotiable instrument, a negotiable document of title, money, or chattel paper, acquired when the collateral was situated in New Zealand.
>
> (2) Subsection (1) does not apply if the security interest is perfected under this Act before the interest referred to in paragraph (a) of that subsection or paragraph (b) of that subsection arises.
>
> (3) A security interest to which subsection (1) applies may be perfected under this Act.

The Bill will apply to an account owed by a foreign company that is payable in Australia, and to an assignment of an account that is payable in Australia (clause 6(2)(b) and (6(2)(c)(ii)). It applies to these accounts because a foreign company might wish to borrow money secured against the account payable in Australia, or assign an account payable in Australia to another person.

If the foreign company were an Australian company, the lender or assignee would be able to use the PPS register to determine whether their loan or assignment would have priority (because Australian law (ie the Bill) would apply to security interests in accounts or an assignment of accounts granted by an Australian company (clauses 239 (1) and (2)).

Similarly, when the lender/assignor is a foreign company, the foreign law will govern the security interest. But the foreign law may not provide for the registration of the loan/assignment. Clause 77 seeks to introduce a level playing field in Australia for foreign companies that borrow against or assign accounts that are payable in Australia. When the foreign law does not have a PPS register (or something similar), clause 77 will allow the lender / assignee to protect their priority by registering the loan / assignment on the PPS Register. This means that prospective lenders / assignees will be able to protect themselves by searching the register and making an appropriate registration.

The clause does not extend to investment entitlements, for the reasons mentioned in the Department's response to Professor Duggan's submission.

The clause does not extend to ADI accounts and other forms of intangible property because a secured party who is unhappy with the law that governs the priority of security interests in the ADI account may negotiate for another law to apply (see clauses 237(1) and 239(5)).

Clause 12(2) and references to leases

The Department cannot comment on 'the view in New Zealand is that leases would not be regarded as security interests under their equivalent to clause 12(1) and (2), despite the express reference to them in their equivalent to clause 12(2)'.

The Bill makes it clear at clause 12(2)(i) that 'a lease of goods (whether or not a PPS lease)' would be a security interest if 'the transaction, in substance, secures payment or performance of an obligation.'

Clause 12(4) Account debtor may have security interest over account

While the Department considers that the Bill has the desired effect (that is, to allow an ADI to take a security interest in an ADI account held by it), consideration could be given to amending the Bill to confirm this.

Clause 39(2)

Consideration could be given to amending the Bill so that the secured party has the benefit of any form of perfection under the law of the originating jurisdiction.

Clause 34(1)(c)(ii)

This clause does not impose an obligation to monitor the collateral. It has the effect that if the secured party does in fact acquire actual or constructive knowledge that the collateral has been transferred, the secured party will lose its priority if it does not re-perfect its security interest within 5 business days.

Clauses 31-52

The different terms reflect different intended policy outcomes.

Serious effects on compulsory acquisition of shares

The complex problem raised here is a problem with the existing law. While the problem could be addressed in the Bill, or through an amendment to the *Corporations Act 2001*, it is not clear how the Bill or the Corporations Act should resolve the problem, which is outside the scope of the PPS Reform. Consideration of this problem could be undertaken as part of a separate policy process.

Clause 69 Priority of creditor who receives payment of debt

Clause 69 is based on section 95 of the New Zealand Act, which provides as follows:

> **95 Priority of creditor who receives payment of debt**
>
> (1) A creditor who receives payment of a debt owing by a debtor through a debtor-initiated payment has priority over a security interest in:
>
> (a) the funds paid;
>
> (b) the intangible that was the source of the payment;
>
> (c) a negotiable instrument used to effect the payment.
>
> (2) Subsection (1) applies whether or not the creditor had knowledge of the security interest at the time of the payment.
>
> (3) In subsection (1), ***debtor-initiated payment*** means a payment made by the debtor through the use of:
>
> (a) a negotiable instrument; or
>
> (b) an electronic funds transfer; or
>
> (c) a debit, a transfer order, an authorisation, or a similar written payment mechanism executed by the debtor when the payment was made.

Section 95 is in turn based on section 31(2) of the Saskatchewan Act, which provides as follows:

> 31(2) A creditor who receives payment of a debt owing by a debtor through a debtor-initiated

payment has priority over a security interest in:

(a) the funds paid;

(b) the intangible that was the source of the payment; and

(c) any instrument used to effect the payment;

whether or not the creditor has knowledge of the security interest at the time of the payment.

(3) In subsection (2), "debtor-initiated payment" means a payment made by the debtor through the use of:

(a) an instrument or an electronic funds transfer; or

(b) a debit, a transfer order, an authorization or a similar written payment mechanism executed by the debtor when the payment is made.

The Department agrees that the submission accurately describes the effect of clause 69.

Both clause 69 and sections 95 and 31(2) require that the payment be made by the debtor.

The submission seems to be suggesting that the clause should apply to a payment by a person who need not be the debtor, and to a person who need not be the creditor. Is it being proposed that the clause should apply to any payment made by a negotiable instrument, electronic funds transfer or other payment mechanism? It would be useful to know how it is proposed the clause should be constrained, and the policy rationale for any extension of the application of the clause.

Clause 69 and related rules dealing with negotiable instruments

The Department agrees with the submission that clause 70 relating to negotiable instruments allows a purchaser of a negotiable instrument for value without notice to acquire the instrument free of the security interest. This is because a purchaser acquires all of the rights in the negotiable instrument, and there is no room for any residual rights in the security interest.

However, when a lesser interest is acquired in the negotiable instrument, clause 70 allows that lesser interest to have priority over the security interest and for the security interest to continue to the extent that both the lesser interest and the security interest are capable of existing together in the negotiable instrument. To the extent that clause 70 allows the security interest to continue in the negotiable instrument, it would be inappropriate to characterise clause 70 as an extinguishment provision.

Clause 81 Rights on transfer of account

The Department considers that the provision has the effect suggested by the submission. Clause 81(1) refers to the 'term in the contract', which in turn refers to the terms relating to accounts mentioned in clause 81(b).

Clause 115(2) Contracting out

The Department considers that the Bill has the effect that any transferee deriving title in the collateral from the original grantor would be bound by any contracting out undertaken by the transferor: on the basis that the transferor could not transfer to the transferee any greater rights against the secured party than the transferor itself held.

The New Zealand Act at section 107 also allows contracting out, and does not expressly deal with whether a transferee is bound by the transferor's contracting out.

Clause 111 Contracting out of commercial reasonableness

Clause 111 provides as follows:

111 Rights and duties to be exercised honestly and in a commercially reasonable manner

(1) All rights, duties and obligations that arise under this Chapter must be exercised or discharged:

(a) honestly; and

(b) in a commercially reasonable manner.

(2) A person does not act dishonestly merely because the person acts with actual knowledge of the interest of some other person.

Clause 111 applies only to '[a]ll rights, duties and obligations that arise under this Chapter'. The Department considers that when a person contracts out of a provision in Chapter 4, the provision no longer applies to create a right, duty or obligation that arises under the Chapter. Accordingly, a person who contracts out of a right, duty or obligation that arises under Chapter 4, also contracts out of clause 111 to the same extent.

The submission suggests that clause 111 'should be clarified so that it does not require a party to disregard its own legitimate commercial interests'. The Department considers that, in determining whether a person has acted in a reasonable commercial manner, a court would allow a secured party to have regard to its own legitimate commercial interest.

Clause 143 Reinstatement

The parties should consider contracting out of clause 143 where the special circumstances of the contract suggest that it may result in practicable problems.

Clause 111 would oblige a person seeking to reinstate a contract under clause 143 to act in a commercially reasonable manner. Clause 111 would apply to preclude reinstatement when this would not be commercially reasonable.

Clauses 163, 164 and 165

The Department considers that these provisions should apply to all assets, charges, or charges over assets in a particular location or of a particular class. For example, in relation to clause 163(1)(a), the registration should be effective until the end time registered for the collateral (so as to avoid the registration continuing indefinitely despite an end time being specified).

Clause 166(2)(c) Temporary effectiveness of defective registration

Clause 166(2)(c) does not place any obligation on the secured party to monitor the collateral. Rather, it effectively obliges the secured party to act within 5 business days after it acquires actual or constructive knowledge of the relevant facts.

Clause 237 Governing law

The Department canvassed the governing law rules in relation to intellectual property in its response to the submission by Professor Duggan.

The rule for accounts and assignment of accounts in clause 237(2) provides legal certainty for third parties. It means that a third party will be able to determine the law that governs all security interests taken in a particular account, or assignments of the account. For example, it will allow third parties to apply the relevant law to determine whether there has been an earlier valid assignment of the account.

Turnover trusts not successfully excluded from vesting provisions Clause 268(2)

The Department notes that clause 268(2) has no precedent in the Saskatchewan legislation. Clause 268(2) would not be relevant in the context of the New Zealand legislation (which does not include a provision corresponding to clause 267(2)).

One option would be to more closely follow the Saskatchewan model and omit clause 268(2) from the Bill.

Clause 268(2) was developed by the Department following extensive consultations with the authors of the submission. The Department considers that there are good policy grounds to depart from the Saskatchewan model to the extent that the provision applies to accounts. The provision exposes unsecured creditors dealing with the junior creditor to the risk that an account owing to the junior creditor may be subject to an unperfected interest in the account (arising from the turnover trust) that will not vest in the junior creditor on its insolvency. The amendment proposed by the submission would further undermine the value of the PPS register as a vehicle for determining the existence of security interests, and would add cost and complexity to the administration of the insolvent estate (as a liquidator would not be able to rely on the PPS register to identify security interests granted by the insolvent company).

Absolute assignments of accounts and chattel paper

Consideration could be given to amending the Bill as proposed by the submission.

Implementation phase

As a result of COAG's decision on 2 July 2009, the new PPS regime will commence in May 2011. COAG took into account the need for an adequate implementation timetable. The Department considers that the proposed implementation timetable (ie May 2011) is adequate.

The Bill will begin to have effect at the 'registration commencement time', which is defined as follows:

> 306(2) For the purposes of this Act, the ***registration commencement time*** is at:
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> (a) the start of the first day of the month that is 26 months after the month in which this Act is given the Royal Assent; or
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> (b) an earlier time determined by the Minister.

Clause 306(2) provides flexibility for commencement of the Bill to be deferred until up to 25 months after the Bill receives Royal Assent.

It is inevitable that some parties will be more prepared than others regardless of the commencement time that is selected. The Department will work to encourage stakeholders to prepare for the new scheme. The Department notes that the Australian Institute of Credit Management has proposed an earlier commencement of the Bill in its submission to the Committee.