Attorney-General's Department

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

This paper comments on the key issues raised in Part 2.1 of the submission by Allens Arthur Robinson, Blake Dawson, Freehills, and Mallesons Stephen Jaques.

Deemed security interests not registrable

An alternative construction for clause 151 is that an applicant for a registration of personal property as collateral need only hold the belief mentioned in that clause when the security interest is of a kind for which the belief may be relevant (that is, that clause 151 does not apply when the security interest is of a kind mentioned in clause 12(3)). The proposed amendment would extend the privacy protections afforded in clause 151 to clause12(3) security interests.

Investment entitlements left out

The Bill has been advanced on the basis that it would not comprehensively address investment entitlements, and that decisions on how Australia should legislate in relation to investment entitlements should be deferred until at least the conclusion of the Convention on Substantive Rules regarding Intermediated Securities (see http://www.unidroit.org/english/workprogramme/study078/item1/conference2009/main.htm) and the Government's consideration of the Convention of 5 July 2006 on the Law Applicable to Certain Rights in Respect of Securities held with an Intermediary (see http://hcch.e-vision.nl/index_en.php?act=conventions.text&cid=72).

The Bill nevertheless includes two rules relating to investment entitlements that are likely to be consistent with the final outcome of the Convention (see clauses 21(2)(c)(ii) allowing security interests in investment entitlements to be perfected by control, and 51 concerning when a person takes an interest in an investment entitlement free of an earlier security interest).

Clause 6 of the Bill does not specify when the Bill would apply to investment entitlements. Whether the Bill applies to investment entitlements in particular circumstances would be determined by the general law. The Bill could be amended to specify the circumstances in which it applies to investment entitlements. However, it is not clear what the rule should be.

The Bill could specify that it applies to an investment entitlement when the investment entitlement intermediary is located in Australia. This would result in the Bill not applying to investment entitlements offered in Australia by a foreign company. Before the Bill could be applied to investment entitlements offered in Australia by a foreign company, it would be necessary to establish rules setting out when an investment entitlement is offered in Australia. These are complex issues, and are likely to be contentious among stakeholders.

One option would be to allow the application of the Bill to investment entitlements to be determined by the general law, pending further consultation with stakeholders in the context of the Government's consideration of the Convention of 5 July 2006 on the Law Applicable to Certain

Rights in Respect of Securities held with an Intermediary and the proposed Convention on Substantive Rules regarding Intermediated Securities.

Flawed assets

The Bill does not provide that a flawed asset is a security interest. Rather, clause 12(2)(l) provides that a flawed asset arrangement is a security interest **when it is a transaction that in substance secures payment or performance of an obligation**. This provision is based on an equivalent provision in the New Zealand Act at section 17(3).

Repos etc should be excluded

The Department considers that these transactions do not create a security interest. The submission notes that:

> We understand that in New Zealand there is a very significant body of opinion that such arrangements are not caught by their PPSA, but debate rages.

This issue could be addressed by regulation made under clause 12(5)(a) to the effect that, for the avoidance of doubt, these arrangements are not security interests. Further consultations would be required with stakeholders to ensure that the regulations are appropriately drafted.

Commingling

The submission suggests that 'the present provisions can provide significantly unfair results by providing that holders of security interests participate according to the value of the amount secured, rather than the value of the asset'.

However, the Bill provides for priority to be limited 'to the value of the goods on the day on which they became part of the product or mass', and not by the 'value of the amount secured' (as suggested by the submission).

The Bill previously considered by the Committee provided for participation according to **the lesser of** the value of the amount secured and the market value of the goods immediately before the commingling: in response to stakeholder comments that this was a more appropriate outcome. Clause 140 of the previous draft of the Bill provided as follows:

> **140 Limit on value of obligation secured by an interest in tangible property that becomes commingled etc.**
>
> For the purposes of this Act, the value (at a particular time) of the obligation secured by a security interest in tangible property that continues in a product or mass under section ^138 does not exceed the lesser of the following values:
>
> (a) the value of the obligation at the particular time;
>
> (b) the market value of the tangible property immediately before the tangible property continues in the product or mass.

The Bill now provides as follows:

> **101 Limit on value of priority of goods that become part of processed or commingled goods**
>
> Any priority that a security interest continuing in the product or mass has over another security interest in the product or mass is limited to the value of the goods on the day on which they became part of the product or mass.

The Bill now reflects the position under the New Zealand and Saskatchewan legislation. The New Zealand Act provides in identical terms as follows:

> **84 Limit on value of priority of goods that become part of processed or commingled goods**
>
> Any priority that a security interest continuing in the product or mass has over another security interest in the product or mass is limited to the value of the goods on the day on which they became part of the product or mass.

This change was made having regard to the Committee's recommendation that the Bill should be amended 'using overseas provisions as often as possible to allow overseas experience to provide guidance for the Australian model', and the strong criticism made of the previous drafting in the course of the Committee's first inquiry into the Bill.

The different outcomes achieved by the Bill as currently and previously drafted are illustrated by the following examples:

Wheat supplied by SP1 valued at $10,000 securing a debt of $1,000 is commingled with wheat supplied by SP2 valued at $1,000 securing a debt of $10,000. Both SP1 and SP2 have a purchase money security interest in the wheat supplied by them.

Under the Bill as presently drafted, SP1's priority is limited to $10,000; while SP2's priority is limited to $1,000. SP1 would have a priority for all of the $1,000 owed to it, while SP2's priority is limited to $1,000 of the $10,000 owed to it. SP2 would continue to have a security interest in the wheat for the remaining $9,000 owed to it, but it would have the same priority as other security interests in the wheat. SP2's position has been improved by the commingling, because prior to the commingling it was unsecured for that $9,000. SP2 is now a secured creditor for the $9,000: to the detriment of the debtor's unsecured creditors.

Under the Bill as previously drafted, SP1's security interest would be limited to the lesser of the obligation secured or the value of the wheat supplied. SP1's security interest would be limited to $1,000. Similarly, SP2's security interest would be limited to the lesser of the obligation secured or the value of the wheat supplied. SP2's security interest would be limited to $1,000. SP2's position is not improved by the commingling of the wheat. SP2 would be unsecured for the remaining $9,000.

Clause 10 – ADI accounts

Implementing this proposal would involve difficult policy considerations. Which foreign financial institutions should have the benefit of the provisions relating to ADI accounts? Would it be sufficient that the foreign financial institution calls itself a bank?

Descriptions

Clause 20(2)(b)(i) requires that the writing evidencing the security agreement contain 'a description of the collateral'. Clause 20(4) goes on to provide as follows:

> If particular personal property is described using the term "consumer property", "commercial property" or "equipment" in the writing evidencing a security agreement, subparagraph (2)(b)(i) is satisfied only if the personal property is more particularly described, in addition, by reference to item or class.

Clause 10 of the Bill provides that:

> ***description*** of personal property (including collateral and proceeds) means:
>
> (a) in the case of a particular item of personal property—a description that identifies the item, or that identifies a class to which the item belongs; or
>
> (b) in the case of a class of personal property—a description that identifies the class.

The Bill obliges the secured party to describe the property that the security interest attaches to. This has a number of benefits. For example, when the secured party later seeks to seize a particular item of property when enforcing the security agreement, the description will determine whether the item is property that the secured party is entitled to seize.

The Department considers that the following descriptions mentioned in the submission—"All equipment", "All equipment at the factory at 17 Jersey Road", "All coal produced at the Lil Abner Mine", "All accounts referred to in [a specified computer print-out]"—would satisfy the requirement of clause 20(2)(b)(i) provided they identify the item or the class to which the item belongs. In other words, is it possible to work out which of the debtor's property is equipment, which of the property at 17 Jersey Road is equipment, whether a particular block of coal was produced at the Lil Abner Mine, or whether a particular account is referred to a specified computer print-out? Resolving these questions will need to be determined having regard to the circumstances at 17 Jersey Road, the Lil Abner Mine and what is written on the computer print-out.

The exclusion of the description 'equipment' is based on the corresponding exclusion in the New Zealand legislation at section 37 and the Saskatchewan legislation at section 10(3).

All assets and other security weakened

The submission suggests that the Bill weakens the value of security to the secured creditor. Although it does not directly say so, the suggestion is that the Bill weakens the value of the security in favour of a person who later acquires another interest in the collateral.

The other person may be another secured creditor who has also taken a security interest in the same collateral. When the Bill weakens the position of one secured creditor, it also strengthens the position of the other secured creditor.

The other person may be a person who has later bought or leased the collateral. When the Bill weakens the position of the secured creditor, it also strengthens the position of the purchaser or lessee.

The Department considers that the core question is not whether the position of the earlier secured party has been weakened: but instead whether the Bill strikes an appropriate balance between the interests of the earlier secured party and the later secured party or buyer/lessee. In most cases, the

earlier secured party will have lent money secured against the collateral, and the later secured party will also have lent money secured against the collateral (or paid the purchase price when the later person is a purchaser or lessee). However, the value of the collateral is insufficient to allow both parties to enjoy the collateral: and the Bill must determine which person should have the benefit of their bargain with the grantor.

As noted by the submission, in a number of the examples mentioned the earlier secured party can protect its security interest by registering its security interest on the PPS register. When the collateral may be registered by serial number, a registration that does not include the serial number will ordinarily provide protection against a later secured party. When the collateral may be registered by serial number, it will be necessary to register by reference to the serial number to provide protection against a later buyer or lessee. This approach means that a later buyer or lessee can determine whether they will acquire good title to the property through a simple search of the register. This is one of the major benefits of the PPS register. The Bill avoids litigation about what the buyer knew or did not know, or what the buyer should have known, and instead favours legal certainty by saying to the secured party that if the security interest is important to them they should register it.

The Department does not agree that all of the examples mentioned in the schedule to the submission weaken the position of the earlier secured party compared to the current law. Time has not permitted a thorough examination of all the items in the list. However, the Department makes the following comments:

- The suggestion that clauses 34 and 68 weaken the position of the transferor's secured party involves an optimistic construction of the Corporations Act (from the secured party's perspective): that is, that a Corporations Act registration by the transferor's secured party against the transferor would be sufficient to give priority over a Corporations Act registration by the transferee's secured party against the transferee. Contrary to the suggestion made in the submission, the Department considers that the Bill enhances the position of the transferor's secured party.
- Clauses 44 and 45 reflect the primacy of the register, and the protection it affords to buyers of serial number property who search the register. The exceptions for inventory and dealers recognise the possibility for fraud in dealer-to-dealer transactions intended to 'wash out' security interests that are not registered by serial number.
- Clause 47 uses an actual or constructive knowledge test (and not merely an actual knowledge test as suggested by the submission): see clause 47(2)(b): 'the buyer or lessee buys or leases the personal property with **actual or constructive knowledge** that the sale or lease constitutes a breach of the security agreement that provides for the security interest' (emphasis added). In contrast, the New Zealand legislation uses an actual knowledge test: see sections 54(1)(b)(ii) and 19(a) referring to the buyer or lessee having 'bought or leased the goods without knowledge of the security interest' and that 'an individual knows or has knowledge of a fact in relation to a particular transaction when that person has actual knowledge of the fact or receives a notice stating the fact'. In recognising constructive knowledge, the Bill strengthens the position of the earlier secured party relative to the later buyer or lessee compared to the position in New Zealand.
- Clause 48 seeks to preserve the effectiveness of currency as a medium of exchange. It provides that a holder of currency takes the currency free of a security interest if the holder acquires the currency with no actual or constructive knowledge of the security interest.

- Clause 49 preserves the effectiveness of purchases undertaken on the stock exchange. A person who buys a share on the stock exchange has no means of identifying the seller of the share, and therefore to determine if the share is subject to a security interest. A secured party would be able to protect themself against this possibility by taking control of the share, and therefore preventing the sale through the stock exchange. Clause 49 gives primacy to the finality of transactions undertaken on the stock exchange (and the integrity this provides for the stock exchange) over the rights of the seller's secured party.
- The submission suggests that clause 50 does not apply 'except where the purchaser actually knew it would breach the charge'. However, the Bill is more favourable to the earlier secured party, who will be protected 'if the purchaser takes the instrument with **actual or constructive knowledge** that the taking constitutes a breach of the security agreement that provides for the security interest' (see clause 50(2)).
- The submission suggests that '[k]nowledge of the transferee is irrelevant, but transferee does not take clear if the intermediary maintaining the entitlement had notice of breach'. However, the Bill provides at clause 51(2) that the transferee's knowledge is relevant (and not that of the intermediary). Clause 51(2) provides that the transferee does not take an investment entitlement free of a security interest when actual or constructive knowledge of the breach is held by 'the person in whose name an investment entitlement intermediary maintains the investment entitlement account'. The knowledge of the account holder is relevant, and not that of the intermediary. The Bill refers to the more generic 'person in whose name an investment entitlement intermediary maintains the investment entitlement account' because the account may be maintained in the name of the transferee or another person on behalf of the transferee.
- The priority given to security interest perfected by control (clause 57) generally reflects the position in Canada and the USA.
- The position in relation to purchase money security interest (clause 62) reflects the position in New Zealand and Canada, and the priority given to purchase money security interests over an earlier registered security interest.
- It is not clear to the Department what the comment the submission is making in relation to clause 66. Clause 66 is an application provision and, by itself, has no effect.
- Clause 69 seeks to maintain the efficiency of debts paid using:

  (a) an electronic funds transfer; or

  (b) a debit, transfer order, authorisation, or similar written payment mechanism executed by the debtor when the payment was made; or

  (c) a negotiable instrument.

  The transferee is at risk only if they have actual knowledge that the payment is made in breach of the security interest. This affords greater protection to the earlier secured party than the New Zealand legislation. In New Zealand the transferee creditor is protected 'whether or not the creditor had knowledge of the security interest at the time of the payment' (section 95(2)).

Clause 79 and ability to transfer despite restriction

The Department agrees that consideration should be given to restricting this clause to provisions in the security agreement, consistent with the New Zealand Act at section 87(1) and the Saskatchewan Act at section 33(2).

The vesting provision in clause 267

The Department considers that:

- The Bill allows a registration that includes an appropriate description to perfect a security interest that attaches to after-acquired property.
- Clause 267 will not apply to a security interest if, in accordance with Part 7.2 of the Bill, the perfection and the effect of perfection or non-perfection of the security interest is governed by a foreign law.
- A secured creditor who is concerned that the grantor may enter into external administration or bankruptcy before the registration occurs should register the security interest before providing the finance. A security agreement made in these circumstances would most likely be void under the *Bankruptcy Act 1966* or the *Corporations Act 2001*.
- The submission does not suggest why clause 269 should apply to all circumstances where the secured party had title to the asset, and lost it by the vesting.

In relation to clause 267, the Committee may wish to consider whether clause 268 should be extended to the interest of a transferee of a transfer of an account or chattel paper that does not secure payment or performance of an obligation (as proposed by Clayton Utz in its submission to the Committee).