SENATE SUBMISSION

1. Introduction

We appreciate the amount of work that has been done in a very short timeframe to address concerns raised in the Senate Committee report. We think that in a number of respects the Bill is a substantial improvement on the previous consultation draft.

We accept that decision has been made on policy to implement the Bill on substantially the terms proposed.

Nonetheless, we have some concerns that in a number of areas the drafting of the Bill is not meeting its policy objectives and can have serious consequences. There have been some reversals of improvements that had been made in the second consultation draft. Those reversals will have a significant adverse effect, particularly in the financial markets.

We set out below our principal concerns. First we list those which require some explanation or exposition and are explained briefly in this submission. We then list briefly a number of other points, which are still important, but require less explanation.

This is not a comprehensive list. We are concerned that, in view of the amount and significance of the changes, and the limited time, there are many other points that we and others will have missed, similar to those mentioned in 2.1(a) and 2.1(b) below. This is significant legislation which will fundamentally change private commercial rights and financing practice.

While we acknowledge that the Act will be reviewed after three years, significant damage can be done in the meantime, at a time in the cycle when the ability of financiers to take security, and the operation of financial markets, are crucial. It is critical to get it right the first time, there is no urgency, and we strongly urge the Senate Committee to repeat its initial recommendation to take time to get it right.

2. Summary of Key Issues

2.1 Issues explained below (see part 3)

(a) **Deemed security interests not registrable** The Bill is internally inconsistent. It forbids parties from registering arrangements which do not secure money but deems certain arrangements which do not secure money (including assignments of accounts) to be security interests and they will need to be registered.

(b) **Investment entitlements left out** Investment entitlements seem to be left out in parts of the Bill, including the provisions which specify when the Bill applies. Despite their similarities to investment instruments they are treated differently or, in some cases, not dealt with.

(c) **Flawed assets** should not be expressly included as examples of security interests (consistent with the consultation draft).

(d) **Repos etc should be excluded** The Bill should clarify that repos and similar arrangements should not be regarded as security interests (as did the consultation draft).

(e) **Commingled goods** While the development is welcome, holders of security interests in commingled goods (particularly fungibles) should share in the mass according to the value of the property contributed to the mass, not the value of the amount secured.

(f) **Clause 10 – ADI Accounts** The provisions relating to ADI accounts should also extend to accounts with other financial institutions, for example, foreign banks, and not be limited to protected accounts.

(g) **Descriptions requirement creates uncertainty** The requirement of descriptions of the collateral for validity can introduce a substantial amount of uncertainty, and potentially invalidate security interests. This may extend to requirements on the register. There should be provision for clarification by examples in the regulations.

(h) **All assets charges and other security weakened** We have done some analysis which shows that the value of an all assets security (and other security) will be significantly weakened when compared to current practice, and when compared with New Zealand. A much larger array of dealings take free of the security interests or take priority even where the party to the dealing has full knowledge of the security interest.

(i) **Clause 79 and ability to transfer despite restriction** This is significantly more extensive than the explanatory memorandum suggests, in allowing transfers despite any agreement with anyone, and can have severe consequences.

(j) **The vesting provisions in clause 267** can inappropriately invalidate some security interests (eg those of future property or governed by foreign law) in a way that we do not think was intended. The "sudden death" operation can operate unfairly. There should be a wider compensation mechanism for vested ownership interests.

2.2 Further issues

Consumer property The references to businesses should include businesses which might not have an ABN, for instance, because they are carried on overseas.

Intellectual property This is limited to statutory forms of property, and not those that arise under general law, like common law trademarks and confidential information. We suggest it should do so.

Clause 77 Priority of unregistered foreign security interests As discussed above, this clause does not extend to investment entitlements, ADI Accounts, and other forms of intangible property and should do so.

This clause also assumes that the foreign law will have concepts of "perfection", which may not be the case (for example, currently Australian law and English law have no concept of "perfection"). In any event, "perfection" is defined by reference to perfection under "this Act", not foreign statutes.

Perfection under other laws. Clause 77 is one of a number of clauses which refer to "perfection" overseas. The concept should be extended (where appropriate) to processes under foreign law under which the security interest becomes effective against other parties. Saskatchewan does this.

Clause 12(2) and references to leases We understand 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 reference in clause 12(2) to leases confuses the position, adds little to 12(3)

Clause 12(4) Account debtor may have security interest over account We wonder why this useful clarification does not extend to ADI accounts and other obligations that are not within the narrow definition of "account". It could simply say an obligor can take security over its own obligation. If there is a policy reason why an Australian bank cannot take advantage of this provision, particularly in relation to a protected account, it should be explained. Clause 75, in contrast, seems to assume an ADI can have a security interest in an ADI Account with it.

Clause 39(2) This leaves a gap for those security interests which under foreign law can be registered but also can be perfected by other means (like possession or control) , and are perfected by those means, as can happen in NZ. This issue could be fixed by adding "and the security interest is so registered" after "under law". If that is done the above case would be covered in sub-paragraph (ii).

Clause 34(1)(c)(ii) This says that a holder of a security interest can be fixed with "constructive knowledge" of transfer and implies duties on the holder of security interests to monitor whether or not the grantor transfers the collateral. This is harsh, more harsh than overseas analogues.

Clauses 31-52 These provisions would be more accessible if the language and concepts were more consistent. The persons entitled to take free of the security interest are described differently in different sections: "buyer", "person who takes", "purchaser" (which is broadly defined) in a way that could be significant but sometimes appears to have no policy driver.

The tests of knowledge are also different (as to whether it is actual or constructive, and whether it is of the security interest or a breach of it) - see the Schedule. In a number of cases the policy reason is apparent, but not others. Different tests may be able to apply in the same circumstances (contrast cl. 44(2) which deals with all serial number property (including motor vehicles) and cl. 45(2) which deals with motor vehicles).

Serious effects on compulsory acquisition of shares Clause 50 gives a mechanism by which purchasers of investment instruments take free of security. It is limited to "consensual" transactions - by doing so it limits the ability of parties completing a takeover through compulsory acquisition or a scheme of arrangement to get full ownership. This could have a significant dampening effect on the efficacy of takeovers.

Clause 69 Priority of creditor who receives payment of debt The payer may not be the "debtor" as defined in the legislation (which is the person that owes the

secured obligation and not the person that owes the debt being discharged). It may be the grantor or another person that owes the obligation. That might be solved by referring to an "obligor" and not a "debtor". Further, the recipient of the payment may not be a creditor. In fact in the example given in the Explanatory Memorandum (clause 2.159) Bank A is not a creditor.

Clause 69 and related rules dealing with negotiable instruments should be moved to the extinguishment provisions and simply state that a person acquiring cash or negotiable instruments for value and without knowledge of an existing security interest acquires free of the security interest – we are concerned that the more limited application of clauses 69 and related provisions dealing with negotiable instruments (including the fact that they operate only as priority rules in favour of particular persons rather than extinguishment rules) could undermine the integrity of our payments system.

Clause 81 Rights on transfer of account If this provision is retained, then it should only invalidate the provision to the extent that it relates to the account, not to the extent it relates to other contractual rights.

Clause 115(2) Contracting out contracting out by a grantor should bind everyone who claims through the grantor, for example, transferees. A particular difficulty is that if the asset has been sold subject to the security interest (as is easily possible under clause 79), then the new grantor (the owner of the asset) is not party to the security agreement and has not "contracted out". Where foreign law is selected as the governing law of a security agreement, the parties should be taken to have contracted out.

Clause 111 Contracting out of commercial reasonableness We had understood from the Government's response to the previous Senate Committee report that it would be possible to contract out of this provision. This change does not appear to have been made. Though now confined to enforcement, the provision will result in extra cost and uncertainty in an area already replete with duties on secured parties. If it is retained, it should be clarified so that it does not require a party to disregard its own legitimate commercial interests.

Clause 143 Reinstatement This will cause significant difficulty particularly where the secured party is required effectively to undo acceleration. In some cases, it may be virtually impossible to restore the position (such as fixed rate loans, foreign currency loans and derivatives).

Clauses 163, 164 and 165 These relate to security interests that describe "particular collateral". This should be clarified, so that, for example, all assets charges are not invalidated, or charges over or assets in a particular location or of a particular class.

Clause 166(2)(c) Temporary effectiveness of defective registration This is an onerous requirement on secured parties because they can be affected by "constructive knowledge" of defects, giving an indication that in some way they may have a continuous duty to check on details.

Clause 237 Governing law The types of property referred to in sub-section (2) should not be subject to a carve-out, but should have the same flexibility.

Otherwise anomalies can arise, in particular, in relation to rights under a contract, some of which are an "account" and some of which are not.

This provision should provide similar flexibility for parties not located in Australia to choose Australian law in relation to assets located in Australia.

Turnover trusts not successfully excluded from vesting provisions
Clause 268(2) is designed to cover turnover trusts in subordination arrangements, but may not cover any of them, in particular because such arrangements are not a security interest in an "account" and because of the cumulative requirements in paragraph (2)(c).

Absolute assignments of accounts and chattel paper Consistent with the second consultation draft and with the treatment of PPS Leases, absolute assignments of accounts and chattel paper which do not secure money should not vest on appointment of an insolvency administrator.

Otherwise the liquidator receives a windfall as the company has received the full purchase price of the asset and the liquidator will also retain the asset or its proceeds.

Implementation phase Our New Zealand colleagues tell us that the proposed implementation period is not nearly long enough. They had a longer period (30 months) in a smaller economy with far fewer financial institutions, but still struggled to be ready.

3. Brief explanation of concerns in 2.1

(a) **(Deemed security interests not registrable)** Most fundamentally, clause 151 needs to be amended. The Bill (clause 12.3) deems certain arrangements (like assignments of accounts and chattel paper, and commercial consignments) which do not secure money to be security interests. Assignees, consignors and others need to register their interests to perfect them but if they do they would breach clause 151 (because they are not able to believe the relevant arrangement will secure money) and suffer a civil penalty.

(b) **(Investment entitlements left out)** The Bill specifies when it applies in relation to all types of personal property (clause 6) except one – investment entitlements, which are investment instruments held through an intermediary, and of increasing importance in global financial markets. There are a number of provisions where investment entitlements are not dealt with at all, or are not treated in the same way as investment instruments or other financial property. For example:

- If an investment instrument is registered in the name of the secured party the secured party is regarded as having control (clause 27(3)). There is no equivalent provision for investment entitlements. Entitlements registered in the name of the secured party are not regarded as in its "control" even though it has "control" in the normal meaning of the word, and it has as much control as it has when it is registered as holder of an investment instrument.
- Clause 32(2) should protect holders of security interests in investment entitlements as well as investment instruments.

- Clause 51 in deciding whether or not a transferee of an investment entitlement takes free of a security interest, looks not at the knowledge of the transferee but at the knowledge of the intermediary. In other words a transferee of an investment entitlement could take free of a security interest even though it has knowledge that would have disentitled a transferee of an investment interest, or an innocent transferee could be burdened with the knowledge of the intermediary. It should be made consistent.
- Clause 77 and clauses 234 to 241 deal with choice of law but do not mention investment entitlements.

A number of provisions which leave out "investment instrument" might be fixed by including investment entitlements in the definition of "financial property" but we have not fully explored this.

(c) **(Flawed assets)** The Bill should follow the second consultation draft and not expressly treat flawed assets as security interests.

An example of a flawed asset is a debt or other contractual right owed to the grantor which is conditional on satisfaction of another obligation. The condition is the "flaw". It is not an interest in an asset or dealing with an asset nor a right in relation to an asset; it is an intrinsic feature of the asset itself (the debt or right) – one of its terms. Concepts like attachment, perfection, priority, vesting and enforcement have no real meaning in that context, and trying to apply them would only cause uncertainty or confusion.

If the condition is not satisfied, either the debt never becomes payable or it is subject to a set-off (effectively the same thing). Including flawed assets is inconsistent with the exclusion of rights of set-off (clause 8.1(d)).

Flawed assets are important - they are, for example, the main way in which parties to ISDA derivative documents protect themselves from counterparty risk.

If for some reason something regarded as a "flawed asset" would be regarded as an interest in personal property securing payment or an obligation, then it would be caught by the general provision in clause 12(1).

(d) **(Repos etc should be excluded)** The Bill should follow the second consultation draft in clarifying that it does not capture repos, credit support annexes, securities loans and similar arrangements, where absolute title to an asset passes, and the counterparty only has a contractual right to a return of an asset of the particular description, or its value, rather than that particular asset. The transferee can, and often does, dispose of the asset. In that case, there is no identifiable asset to which the relevant provisions could properly apply. See clause 6(1)(f))(ix) and (x) of the consultation draft.

There seems to be little point in adding them as security interests. As stated above, there is no asset in relation to which there can be priority, or enforcement.

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. We understand in the USA such arrangements are the subject of a "safe harbour". Australia should take the opportunity to clarify the position and exclude them.

(e) **(Commingling)** The provisions designed to allow security interests in commingled goods to continue are very welcome. For example, it may assist financing of agricultural and other fungible commodities by allowing someone to take a security interest over a portion of a whole stock. However, 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.

For example, take the case where 10,000 bushels of wheat charged to X to secure $10,000 are mixed with 1,000 bushels charged to Y as part of security which secures $100,000. Under the Bill, X gets one eleventh of the "pot" and Y ten elevenths, despite having contributed in the reverse proportions.

(f) **(Clause 10 – ADI Accounts)** The provisions relating to ADI accounts should also extend to accounts with other financial institutions, for example, foreign banks. Why, for example should an Australian corporation's account with ANZ in Hong Kong be treated differently from its account with Standard Chartered in Hong Kong? They should extend to all accounts with an ADI, not just "protected" ones. The degree of Commonwealth support of the account, or supervision of the institution, is irrelevant to the manner in which the customer should be able to give security over the account.

(g) **(Description)** Clause 20 may not be sufficiently precise as to what description may suffice. This will either mean very conservative treatment of the clause with elaborate descriptions which will add to the expense of taking security and limit flexibility, or a mass invalidity if this clause is given a more conservative interpretation than the market generally applies.

In particular, we do not see why a description of "all equipment" should be invalidated. It should allow descriptions such as "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]".

At the very least, the Bill should make provision for regulations which would clarify the types of descriptions that can be adequate.

We are also concerned as to what the appropriate description should be, where for example there is a physical asset, like a certificate which is not a document of title, which represents a financial property or other asset. Is it "goods" or "financial property"? This issue extends to the requirement to have separate registrations.

(h) **(All assets charges and other security weakened)** The great benefit of current law is the all assets charge. It is the main mechanism by which companies give security. It can be created simply by one document, and offers significant protection.

We have done some comparative analysis of which the Senate Committee should be aware. We compared the position of all assets chargee under the Bill with the position under current law and in New Zealand.

In each case (by comparison with current law and New Zealand) it shows the value of the security significantly weakened.

Under current law, in relation to personal property, if it is registered with a generous prospective liability cap, it could only lose priority to parties taking:

- existing interests in the property before attachment;
- statutory charges;
- legal interests for value without notice of the charge;
- in the case of the floating part of the security only (which the parties could select), dealings in the ordinary course of business,
- in certain cases, assets under REVS;
- In certain cases to subsequent holders of equitable interests who had no notice of its interest, or where it failed to give notice to an account debtor.

In most cases the key feature is that someone could not take priority over a charge, or the asset free of the charge, if they had notice of the charge.

Under the Bill a security interest can lose priority or title to a much larger group of dealings in a much wider set of circumstances. These are enumerated in the Schedule to this submission. In many cases this applies <u>whether or not the other party had notice of the charge</u>. In a number of cases this contrasts with the position in New Zealand.

In particular, in contrast to the current position, and to a large extent New Zealand, a holder of an all assets security interest will have to take control over all assets where perfection can be by control, and make particular registrations for all property registrable by serial number, in order to preserve its position even against parties with notice of its security interest. This will significantly detract from the "one stop shop" benefit and add to costs.

This is compounded by the grantor's ability to transfer the collateral under clause 79, which means that a secured party cannot stop a transfer which would cause it to lose priority or its security interest over the asset - it can only enforce after the event.

(i) (**Clause 79 and ability to transfer despite restriction)**. We don't understand the policy behind this provision. It may have a number of serious effects.

First, it will have a much wider application than described in the Explanatory Memorandum: subsection (1) isn't limited to restrictions in agreements between the Grantor and the secured party. It will apply to restrictions in any agreement between any party. It would allow property to be transferred despite restrictions in any agreement with any party just because it happens to be collateral secured to another party. This has a number of serious consequences.

- It could weaken the efficacy of documents with an ADI or intermediary which give the secured party "control" as defined in clause 25 or 26 over an account or investment entitlement by restricting dealing with the account.
- It could allow a party despite a prohibition in the contract to assign any contract which happened to be collateral. This freedom is not just confined

to the circumstances covered by section 81. This may in particular prejudice the position parties who wish to preserve future set-offs

Second, even if it is restricted to agreements between the Grantor and the secured party, by extending the provision to goes beyond foreign analogues. It could have a serious effect when the security agreement happens to be just one of a number of agreements between the parties. For example this could allow parties to transfer interests in joint ventures in breach of restrictions in the joint venture agreement simply because there are cross charges between the parties or one of them has given security to a bank.

In any event, given the ease with which the secured party can lose its rights over the transfer of collateral (which at least exceed those in New Zealand, see the Schedule), this would seem to be a significant weakening of the position of secured creditors.

(j) **(Vesting of unperfected interest on insolvency)** Clause 267 vests unperfected security interests in insolvency administrators. There are a number of serious problems with the current drafting.

- It leaves in doubt the efficacy of security over after-acquired property, because the security interest over property acquired after the relevant time would not have been perfected at the relevant time, and it would therefore vest in the insolvency administrator – this should be clarified.
- Because "perfection" is defined in Australian concepts and terms (see above), holders of security interests governed by foreign law will not be "perfected" as defined, and may find their security interest vesting.
- It gives a very sudden cut-off time and may give a holder of a security interest no time to perfect an interest by registration. For example, if the security interest was created on the morning of an appointment of an administrator, and there is no provision for a court to give an extension of time for registration (unlike under the Corporations Act).
- Clause 269 should be wider in covering all circumstances where the "secured party" had title to the asset, and lost it by the vesting.

SCHEDULE

Interests, other than prior interests, that can prevail over a standard registered all assets charge under the Bill (often subject to exceptions not necessarily stated below)

Note, unlike the current Corporations Act register, there is no provision for registration of restrictions on dealing with collateral, and so it is unlikely buyers etc will be actually aware of those restrictions and therefore they are very unlikely to have "actual knowledge" of that breach as my provisions require. This list is not complete.

- Where collateral is transferred, and the security interest is not re-registered within 2 years or, if earlier, 5 business days after the secured party becomes actually or <u>constructively</u> aware (clauses 34, 68).
- Buyer or lessee of serial number property (including motor vehicles), for value, in certain cases if the security interest is not correctly registered against that serial number (clauses 44 and 45). With motor vehicles in some cases this does not apply if the buyer or lessee was aware of the charge. However with serial number property generally (clause 44) and sales of motor vehicles by dealers it applies even if the buyer or lessee was aware of the charge (except where the buyer or lessee actually knew it would breach the charge). *In NZ transferees which had notice of the security interest are not free of the security interest.*
- Buyer or lessee of personal property sold or leased in the ordinary course of the seller's or lessor's business (clause 46). It applies even if the buyer or lessee was aware of the charge (except where the buyer or lessee actually knew it would breach the charge).
- Buyer or lessee of personal property, for value, that the buyer or lessee intends to use predominantly for personal, domestic or household purposes, subject to a monetary value cap (clause 47). It applies even if the buyer or lessee was aware of the charge (except where the buyer or lessee actually knew it would breach the charge). *In NZ it doesn't apply where buyer or lessee had knowledge of the security interest.*
- Taker of currency (clause 48) (even if it is proceeds that the security interest attaches to under clause 32) with no actual or constructive knowledge of the security interest. *In NZ knowledge irrelevant.*
- Buyer of investment instrument or investment entitlement in the ordinary course of trading on certain Australian stock exchanges (but not overseas exchanges) (clause 49). Knowledge of buyer irrelevant. *No equivalent in NZ.*
- 'Purchaser' (extended meaning) of investment instrument, for value, and where the purchaser takes possession or control (clause 50). It applies even if the purchaser was aware of the charge (except where the purchaser actually knew it would breach the charge). *In NZ this is only the case for purchasers in the ordinary course of their business; others only take free if they took without actual or constructive notice of the charge.*

- "Taker of interest" in investment entitlement (clause 51). Knowledge of transferee irrelevant, but transferee does not take clear if the intermediary maintaining the entitlement had notice of breach. *No equivalent in NZ.*
- Security perfected by control (which can only apply to ADI accounts, investment entitlements, investment instruments, negotiable instruments not evidenced by a certificate, rights evidenced by letters of credit that must be presented, satellites and other space objects) (clause 57). *No equivalent in NZ, in NZ priority is generally according to order of perfection.*
- Purchase money security interest (clause 62). Knowledge of PMSI holder irrelevant.
- Transferor granted security interests (clause 66)
- Creditor receiving payment of debt (clause 69). It applies even if the purchaser was aware of the charge (except where the purchaser actually knew it would breach the charge) *In NZ knowledge irrelevant*
- Taker of negotiable instrument, chattel paper, or negotiable document of title, in each case for value (clauses 70, 71 and 72). For purchasers in the ordinary course of their business, it applies even if the purchaser was actually or constructively aware of the charge (except where the purchaser actually knew it would breach the charge). For others it only applies if they took without actual or constructive notice of the charge *In NZ broadly the same but, except for chattel paper it looks at whether it is in the ordinary course of the transferor's business, and for chattel paper*
- Statutory or general law liens (clause 73). For purchasers in the ordinary course of their business, it applies even if the lienee was aware of the charge (except where the lienee actually knew it would breach the charge).
- Security interest held by an ADI in an ADI Account except where charge is perfected by control (clause 75). Knowledge of ADI irrelevant. *No equivalent in NZ*
- Crop or livestock security interests granted to fund production of crops or feeding or development of livestock (clauses 85, 86). Knowledge irrelevant,
- Accessions (clause 89 and following)
- Commingled goods - security interests can rank pari passu but according to amounts secured, not assets contributed (clause 102).