CHAPTER 5

Unresolved technical issues

Introduction

5.1 A number of substantive matters which were the subject of recommendations in the March 2009 exposure draft report have been resolved to the general satisfaction of most who were involved in the process of inquiry into the proposed legislation. These matters were discussed in Chapter 3 above.

5.2 However, the committee has been unable to reconcile many of the other technical issues raised with it. Most of these matters have emerged since the 2009 Bill was introduced, but a few remain from the time of the inquiry into the exposure draft.

5.3 Some of the submissions also convey serious concern that in the relatively short period of time available to read and analyse this lengthy Bill it has not been feasible to ensure that all, or even most, issues have been identified. This matter has been discussed earlier in the report, but it is relevant to repeat it here. As the submission from the combined law firms stated:

> 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…below. This is significant legislation which will fundamentally change private commercial rights and financing practice.
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> …
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> …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.[1]

5.4 As noted in Chapter 4, the timeframe for this report is also quite short and in the time available it is not even possible to describe in detail all of the concerns, let alone to substantively consider them. The approach the committee has taken is to consider a sample of the matters raised in some depth, to provide a brief outline of concerns the department commented on and to list the other issues brought to its attention by stakeholders.

5.5 The committee intends that all of these matters will be responded to by the government in accordance with Recommendation 1 in this report.

Some examples of concerns raised that are discussed in some detail

5.6 These are examples of a couple of concerns which are outlined to demonstrate some of the issues brought to the committee's attention.

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1 Allens Arthur Robinson, Blake Dawson, Freehills, Mallesons Stephen Jacques, *Submission 17*, p. 1.

5.7 There are also other concerns that have been raised with the committee which, in the committee's view, are unresolved. However, there is insufficient time to examine them more closely. These are listed later in the chapter.

Paragraph 14(2)(c)- meaning of* purchase money security interest *in relation to collateral intended for personal, domestic or household purposes

5.8 This proposed clause is new since the exposure draft bill. The effect of paragraph 14(2)(c) has given rise to some comment, including concern about its possible impact on the availability of consumer finance.

5.9 A security taken by a financier for a specific asset is commonly made in the form of a *purchase money security interest* (PMSI). A PMSI is a security interest in collateral. The purpose of a PMSI is to give priority to a security interest for the specific asset. This provides an incentive to the financier for providing security for the asset, especially in circumstances where the purchaser has given an all-assets security to another financier.

5.10 Paragraph 14(2)(c) provides an exception to the usual operation of a PMSI. As Piper Alderman explained in its submission:

> The effect of this sub-clause is that it will not be possible to have a purchase money security interest (PMSI) in collateral that the grantor intends to use for personal, domestic or household purposes.[2]

5.11 For example, paragraph 14(2)(c) would mean that an existing general security over all current and after acquired property (such as is commonly given by a small business to a bank for an overdraft) is given priority over the security of a subsequent financier of non-serial numbered consumer goods (such as an electrical goods store which finances the purchase of a large television).

5.12 In support of this approach, the Australian Institute of Credit Management observed that:

> AICM notes the wording of this section and believes its inclusion will be of considerable benefit when a credit provider obtains a guarantee (for example a director's guarantee) as this will preclude the erosion of the value of the guarantee.[3]

5.13 On the other hand, Piper Alderman argues:

> In the absence of sub-clause 14(2)(c) a consumer financier would not need to be concerned about a prior registered non-PMSI security interest. If sub clause 14(2)(c) remains in the Bill a consumer financier's only security is potentially at risk unless they undertake searches and obtain a release or subordination from the holder of the prior registered security interest if that interest could extend to the consumer goods being financed by the consumer financier.

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2 Piper Alderman, *Submission 2*, p. 1.

3 Australian Institute of Credit Management, *Submission 12*, p. 4.

> While sub-section 14(2)(c) is unlikely to be a concern in the context of financing arrangements for serial numbered goods which the grantor intends to use for personal, domestic or household purposes (due to the operation of other provisions in the Bill), it could increase the cost of consumer finance for non-serial numbered goods.[4]

5.14 Other submitters also expressed concern about the approach taken in the Bill, including the Australian Bankers' Association and the Australian Finance Conference.[5]

5.15 The divergent views held about this clause seem to be based on different ideas about the policy issue the clause seeks to address and both views appear reasonably arguable.

5.16 It is appropriate for the Bill to take a stance and make clear which party is to receive priority (currently the all-assets security holder over the consumer goods financier). However, it seems to the committee that perhaps this is an example of when it would be beneficial for the government to provide greater transparency about the reasoning behind its policy choices to better inform the debate about why the chosen approach was preferred and to assist stakeholders to prepare for its implementation.

"Flawed assets"

5.17 Clause 12 of the Bill, which will prescribe the meaning of *security interest*, now provides that a security interest includes "a flawed asset arrangement".

5.18 The combined law firms' submission asserts that the Bill should not expressly treat flawed assets as security interests. As they explain:

> 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.
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> 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)).
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> …
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> If for some reason something regarded as a "flawed asset" would be regarded as an interest in personal property securing payment or an

4 Piper Alderman, *Submission 2*, p. 4.

5 Australian Bankers' Association, *Submission 14*, p. 2 and the Australian Finance Conference, Additional Information, p. 2.

> obligation, then it would be caught by the general provision in clause 12(1).[6]

5.19 The department's response to this concern is that "clause 12(2)(1) 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).[7]

5.20 In reply, the combined laws firms noted that:

> The fact that [flawed assets] are given as examples can give rise to confusion and uncertainty, as the courts try to make provisions of the Act apply to something to which they don't naturally apply. The treatment of flawed assets as a security interest would be all the more anomalous given that they are most analogous to (and used as an adjunct to) rights of set-off, which are specifically excluded.
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> What would make the inclusion more serious than in New Zealand is the insolvency vesting provisions (which are absent from the NZ Act).[8]

5.21 In the absence of other information, it seems possible that the clause 12(2)(l) reference to "a flawed asset arrangement" was included by the department in response to the committee's March 2009 injunction in Recommendation 1 to reconsider the Bill with a view to, among other things, "using overseas provisions as often as possible to allow overseas experience to provide guidance for the Australian model".

5.22 As described elsewhere is this report, the committee sincerely commends the department for the considerable reworking of the Bill. It is apparent that the government has sought to genuinely review the Bill in response to the committee's March report. In particular, the drafting style is now similar to that in the Canadian and New Zealand legislation and is relatively simpler and more accessible.

5.23 In many respects the current Bill is closer to overseas provisions, but in other respects the proposed legislation has been drafted to deal with Australian circumstances. This approach has advantages (such as adapting legislation to meet specific Australian needs and improving on overseas legislation where this is desirable), but it also has disadvantages (such as not being able to get the full benefit of overseas experience and precedent).

5.24 Given the importance of this legislation the committee believes that it is appropriate to reconsider the approach taken to "overseas" clauses where significant concerns about the approach have been raised.

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6 Allens Arthur Robinson, Blake Dawson, Freehills, Mallesons Stephen Jacques, *Submission 17*, p. 6.

7 Attorney-General's Department, Attorney-General's response to issues raised by Allens Arthur Robinson, Blake Dawson, Freehills and Mallesons Stephen Jaques, *Additional Information*, Wednesday 5 August 2009, p. 2.

8 Allens Arthur Robinson, Freehills, Mallesons Stephen Jacques, *Additional Information*, 10 August 2009, pp 2 and 3.

5.25 For example, if the only reason that clause 12(2)(l) is included in the Bill is to make it similar to overseas provisions then, given that the government has already taken the approach of drafting legislation that incorporates provisions that take into account Australian circumstances rather than directly adopting an existing overseas model, and given the concerns raised about it its inclusion, it should be reviewed.

Concerns raised in submissions which the department agrees warrant further consideration

5.26 This section of the report outlines matters which the department commented on in evidence to the committee. In relation to some of these matters, the department conceded that they need serious consideration and will probably result in amendments to the Bill.[9]

5.27 The committee particularly acknowledges the approach the department took to assist the inquiry by identifying a range of issues likely to be of interest to the committee and offering comments on them. The department's responsiveness to the committee and willingness to genuinely engage with the process is greatly appreciated.

5.28 In identifying matters that may be considered further, the department emphasised the point that it is ultimately a matter for government to determine which of these areas, if any, give rise to changes to the final effect of the Bill.

Clause 55(4) - priority time and control

5.29 This clause seeks to allocate priority in certain circumstances, as follows:

> 55 Default priority rules
>
> (4) Priority between 2 or more security interests in collateral that are currently perfected is to be determined by the order in which the priority time (see subsection (5)) for each security interest occurs.

5.30 The department advised the committee that during the attempt to align this clause with the Saskatchewan approach an inadvertent change was made and this needs to be corrected to give it the effect that it should have.[10]

5.31 This is a possible amendment to the Bill that the department considers should not be controversial.[11]

Clause 268 – Turnover trusts not successfully excluded from vesting provisions

5.32 An issue with this clause raised in the combined law firms submission is that:

> Clause 268(2) is designed to cover turnover trusts in subordination arrangements, but may not cover any of them, in particular because such

9 Mr Patch, *Proof committee Hansard*, Friday 7 August 2009, p. 9.

10 Mr Patch, *Proof committee Hansard*, Friday 7 August 2009, p. 9.

11 Mr Patch, *Proof committee Hansard*, Friday 7 August 2009, p. 9.

> arrangements are not a security interest in an "account" and because of the cumulative requirements in paragraph (2)(c).[12]

5.33 The department has considered the concern and agrees that this clause:

> …needs to be amended so that silent accounts and chattel paper that do not secure performance or paper obligation are exempted from section 267 so that those security interests will not vest in the grantor on insolvency but will be affected by the priority rules.[13]

5.34 This is a possible amendment that the department considers should not be controversial.[14]

Clause 79 – transfer of collateral despite prohibition in security agreement

5.35 This clause seeks to provide that collateral can be transferred despite a provision in an agreement 'whether or not a security agreement' prohibiting the transfer.

5.36 The complaint about this clause is that 'it will have a much wider application than described in the Explanatory Memorandum' and has 'a number of serious consequences.'

5.37 In response to the concern raised the department expressed the view that this clause:

> …overreaches slightly to the extent that it applies to agreements other than security agreements, and we think we should wind it back a bit to make it consistent with approaches taken in New Zealand and Canada.[15]

5.38 This is a possible amendment that the department considers should not be controversial.[16]

Sub-clause 39(2) – relocation of collateral

5.39 Proposed section 39 provides for continuous perfection in certain circumstances when an asset is moved from overseas to Australia. It provides the benefit of enforceability against third parties in the originating jurisdiction that would otherwise be lost as a result of moving the asset.

5.40 As currently drafted, if the foreign jurisdiction has a system for registering security interests the clause would apply when registration of the security interest occurs. However, this application of the clause is not quite complete. As the department describes, this sub-clause:

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12 Allens Arthur Robinson, Freehills, Mallesons Stephen Jacques, *Additional Information*, 10 August 2009, p.5.

13 Mr Patch, *Proof committee Hansard*, Friday 7 August 2009, p. 9.

14 Mr Patch, *Proof committee Hansard*, Friday 7 August 2009, p. 9.

15 Mr Patch, *Proof committee Hansard*, Friday 7 August 2009, p. 9.

16 Mr Patch, *Proof committee Hansard*, Friday 7 August 2009, p. 9.

> …should trigger the benefit of enforceability against third parties in the originating jurisdiction. This relates to where property is moved from, say, New Zealand to Australia. The Bill currently says that you get the benefit of a registration in New Zealand but you do not get the benefit of perfection of a different kind in New Zealand. We think it should be amended so that when property is moved to Australia you get the benefit of the earlier priority time from the earlier registration or earlier perfection in the previous jurisdiction.[17]

5.41 This is a possible amendment that the department considers should not be controversial.[18]

Clause 77 – Priority of certain security interests if there is no foreign register

5.42 The issues raised in relation to this clause include that it should extend to some other forms of intangible property and that it assumes that the applicable foreign law in a given matter will have concepts of "perfection", which may not be the case.[19]

5.43 The department has responded to the complaint with some explanation of the operation of the clause.[20] In evidence to the committee the department also stated that this clause raises a drafting question and:

> …should be amended so that it applies to all kinds of security interests. The description…of perfection of originating jurisdiction is an error. We think section 77(1) already has the effect that it does not apply to the deemed security interests. The major law firms said they think that is a strange reading of the section. We propose to take it back to the drafters and see if we can do something about that.[21]

5.44 It follows that this is a matter which requires further work in order to make the proposed provision fully effective.

Clause 151 – Registration – belief that collateral secures obligation

5.45 The issue raised in relation to this clause is that on one interpretation it requires parties to register their security interests to perfect them, but in doing so assignees, consignors and others "…would breach clause 151 (because they are not able to believe the relevant arrangement will secure money) and suffer a civil penalty."[22]

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17 Mr Patch, *Proof committee Hansard*, Friday 7 August 2009, p. 9.

18 Mr Patch, *Proof committee Hansard*, Friday 7 August 2009, p. 9.

19 Allens Arthur Robinson, Freehills, Mallesons Stephen Jacques, *Additional Information*, 10 August 2009, p. 2.

20 Attorney-General's Department, Attorney-General's response to issues raised by Allens Arthur Robinson, Blake Dawson, Freehills and Mallesons Stephen Jaques, *Additional Information*, Friday 7 August 2009, p. 2.

21 Mr Patch, *Proof committee Hansard*, Friday 7 August 2009, p. 9.

22 Allens Arthur Robinson, Blake Dawson, Freehills, Mallesons Stephen Jacques, *Submission 17*, p. 5.

5.46 The department has outlined an alternative construction of the clause as drafted,[23] but acknowledged the issue and '…proposes to go back to the drafters to see whether the drafting can be improved on.'[24]

Office of the Privacy Commissioner's issues

5.47 The Office of the Privacy Commissioner and the department have given evidence of working effectively together on the PPS legislation.[25] In this spirit, the Office of the Privacy Commissioner has outlined a number of issues that it believes still need to be resolved.[26]

5.48 The department indicated that there are matters that it agrees may require consequential amendments to the Privacy Act and it will discuss these further. In addition:

> There are a couple of other issues to do with possible amendments to the PPS Bill. I think we need to have further discussions with the Privacy Commissioner and the Department of the Prime Minister and Cabinet, which administers the Privacy Act, to clarify what needs to happen there and to make sure that the scheme is consistent with the Privacy Act.[27]

5.49 The department is of the view that no legislative amendments are required to address the recommendations in the Privacy Impact Assessment.[28] The government has provided a formal response to the assessment which indicates that 13 of the 14 recommendations have been accepted in full.[29]

5.50 These are matters that need to be considered further before they are fully resolved.

Clause 267 – Vesting of unperfected security interests in the grantor upon the grantor's winding up or bankruptcy

5.51 This is a lengthy clause that generated a number of concerns.[30] The department commented on two aspects raised: attachment after insolvency and the application of the *zero hour rule*.

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23 Attorney-General's Department, Attorney-General's response to issues raised by Allens Arthur Robinson, Blake Dawson, Freehills and Mallesons Stephen Jaques, *Additional Information*, Wednesday 5 August 2009, p. 1.

24 Mr Patch, *Proof committee Hansard*, Friday 7 August 2009, p. 9.

25 Mr Pilgrim, *Proof committee Hansard*, Thursday 6 August 2009, p. 13.

26 Office of the Privacy Commission, *Submission 8* , pp 4 to 6.

27 Mr Glenn, *Proof committee Hansard*, Friday 7 August 2009, p. 9.

28 Mr Patch, *Proof committee Hansard*, Friday 7 August 2009, p. 10.

29 A copy of the response can be found at the committee's website at: http://www.aph.gov.au/senate/committee/legcon_ctte/pps_2009/submissions.htm.

30 See for example, Allens Arthur Robinson, Freehills, Mallesons Stephen Jacques, *Additional Information*, 10 August 2009, p. 9.

5.52 In commenting on the attachment after insolvency concern Mr Patch described the problem as follows:

> It relates to the continuing effect of a registration after a company becomes insolvent, and whether the registration should stop when insolvent. It is a very technical point. I think we can resolve that in a way that will make [stakeholders] happy; I just need to work out how to do it.[31]

5.53 In commenting on the application of the *zero hour rule* concern Mr Patch described the problem as follows:

> The zero-hour rule is a technical rule that says a company is deemed to become insolvent on the first minute of the day the courts make an order for its winding up. So if someone makes a registration at 10 am but the court makes an order winding it up at noon then the company is deemed to have become insolvent the midnight before that. So in a sense the company is insolvent before the registration is made. It is a very technical sort of thing and we need to fix it up. I think the person at Allens who picked this up did very well.[32]

5.54 This is a matter the department considers warrants discussions with stakeholders.

Clause 115(2) – successors in title bound by earlier contracting out

5.55 Clause 115 describes circumstances in which the parties to a security agreement can contract out of enforcement provisions in the Bill. The aspect of concern is whether clause 115(2) binds not only the grantor but also anyone who claims through the grantor, such as a transferee.[33]

5.56 The department considers that this warrants discussions with stakeholders. The department made the point that:

> Successors in title bound by earlier contracting out is something that we need to talk to them about; it is not a feature of New Zealand legislation. If something can be done quickly that does not take up too much space. We think it has this effect already, for the reason we have explained in our response to the Allens submission; we just need to talk to them about it a bit more now.[34]

Mortgage backed securities and securities lending arrangements

5.57 Some technical issues were raised with the committee in relation to mortgage backed securities and securities lending arrangements. In evidence the department told the committee that this is a matter that:

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31 Mr Patch, *Proof committee Hansard*, Friday 7 August 2009, p. 10.

32 Mr Patch, *Proof committee Hansard*, Friday 7 August 2009, p. 10.

33 Allens Arthur Robinson, Freehills, Mallesons Stephen Jacques, *Additional Information*, 10 August 2009, p. 4.

34 Mr Patch, *Proof committee Hansard*, Friday 7 August 2009, p. 10.

> …we think could be addressed in the regulations about mortgage backed securities. They want to make it clear that these security interests are governed by the bill. We attempted to put them in the bill but the drafter said it would go to five or six pages. It is a very technical thing that affects maybe half-a-dozen law firms. We thought, "Well, we'll just put it in the regulations rather than spell it out in the bill.' The same goes for securities lending arrangements. These are very technical and it is important to get them absolutely right. We have the capacity to amend the regulations if it turns out that we get them wrong. Both these things are incredibly technical and it would be very important to get the slight nuances of the drafting right…What we are saying here is that we are looking to do something that they want us to do, and we need to discuss exactly how to do it.[35]

Other matters

5.58 The time available for hearings did not allow the department to finish its evidence about matters raised in submissions. To rectify this the department undertook to answer a question on notice to complete its comments on issues it sought to bring to the attention of the committee.

5.59 Further concerns were also raised with the committee that were not specifically commented on by the department.

5.60 The committee has listed many of these issues and concerns in a table at Appendix 4 as it is intended that they will be considered by the government as part of its response to Recommendation 1.

Conclusion

5.61 The committee is aware that its recommendation in Chapter 4 is somewhat unusual. However, this inquiry has some unusual circumstances: there have been several years of policy development and consultation, the level of reform and the magnitude of the Bill are significant and the scheme requires the detailed cooperation of the states and territories for its legislative foundation and also for it to be implemented effectively.

5.62 In formulating its approach the committee has considered the needs of the various stakeholders, including the federal, state and territory governments, business and their advisers as well as consumers. The committee does not want the process to be unnecessarily delayed, but is also conscious of the genuine concerns raised by submitters about the recent timeframe and about some areas of the Bill that would benefit from amendment to correct errors and other aspects of concern. As outlined above, a number of these areas have been acknowledged by the department.

5.63 The purpose of the recommendation is to allow the Bill to proceed, but to also identify a way in which areas that still require improvement can be identified and made quickly and that will take effect at the commencement of the act. The recommended further period of consultation and the provision to stakeholders of more information about policy choices is expected to provide stakeholders with the

35 Mr Patch, *Proof committee Hansard*, Friday 7 August 2009, p. 10.

opportunity to consider the Bill in further detail and for the department to continue its work to review and finalise the scheme through consequential amendments to the Bill.

Recommendation 2

5.64 That subject to the foregoing recommendation, the Bill be supported.

Senator Trish Crossin

Chair