APPENDIX 3

Supplementary Submission provided by Allens Arthur Robinson, Blake Dawson, Freehills and Mallesons Stephen Jacques

Background

Towards the end of the public hearings into the *Personal Properties Securities (Consequential Amendments) Bill 2009* (the ***PPS Bill***) that were held by the Senate Standing Committee on Legal and Constitutional Affairs on 10 November 2009, we were asked by Senator Fisher to provide some further commentary on two issues that the Committee had raised with both us and representatives of the Attorney-General's Department at that hearing.

We responded with a Supplemental Submission on 16 November 2009.

The Attorney-General's Department made subsequent comments in relation to our Supplemental Submission in relation to one of those issues relating to clause 101 of the PPS Bill.

Our further response in relation to those issues are set out below.

Example 1

Our original example was as follows:

> *Glenn's Gold Emporium is a wholesale supplier of gold to the jewellery manufacturing market. It supplies gold on retention of title terms, and registers its security interests in accordance with the Act.*
>
> *A small but important customer of Glenn's Gold Emporium is an up-and coming boutique producer of reproduction antique rings, Patchworks. Glenn's Gold Emporium sells $100 of gold to Patchworks.*
>
> *Patchworks also maintains a number of banking facilities with Bobbin Bank. Patchworks has not given Bobbin Bank an all-assets security, but instead has given Bobbin Bank a security interest over all its stock of rings. Bobbin Bank has also perfected its security interest over the rings by registration.*
>
> *The gold price is notoriously volatile, and shortly after the sale of gold by Glenn's Gold Emporium to Patchworks, the price goes into a slump. Glenn's Gold Emporium is still owed $100 by Patchworks, but the value of the gold that it sold has now dropped to $80. This happens to still be the price on the day on which Patchworks uses the gold to make some rings. As a continuation of the*

> *price volatility, the slump reverses itself a few days later, and the gold price recovers to its previous level.*
>
> *Before Patchworks uses the gold to make rings, Glenn's Gold Emporium clearly has priority, and for its full $100.*

Under clause 99 of the PPS Bill, Glenn's Gold Emporium's security interest in the gold continues into the ring. Because of the vagaries of the world gold price and the coincidental timing at which Patchworks used that gold to make some rings, however, its priority under clause 101 is limited to $80, even though Glenn's Gold Emporium is owed $100 and the current market value of the gold in the rings is now back at $100 as well.

The Department in its response addressed the example on the assumption the gold is not mixed with anything else in manufacturing the ring..

Our point is more clear if it is assumed that the rings are manufactured not only from the gold supplied by Glenn's Gold Emporium, but also from some gold held in stock by Patchworks, and some silver supplied by Archimedes Ltd without any retention of title or other PMSI, which is alloyed with the gold. The gold supplied by Glenn's is worth $100 on supply, $80 on commingling, but at the time of sale of the ring, would have been worth $100 if separate.

Say the ring, taking into account the increased value of the gold supplied by Glenn's, the gold and silver of Patchworks, and its design, is worth $200.

At that stage, clause 99 clearly applies as the identity of the gold has been lost in the product or mass. The difficulty arises under section 101. That limits priority to the $80 value on commingling.

Under our example, Glenn's is owed $100, but is only entitled to recover $80, even though the value of its contribution has increased to $100. s103 might have helped but it does not override section 100.

A more stark example of the operation of the section in relation to non-fungibles is the following example.

Example 1A

> *Glennbank has a perfected security interest over 800 oz of gold , which secures (with other assets) $1,000,000. The other assets subject to its security are dissipated. The gold is worth $400,000 at the time of commingling, and the price of gold subsequently rises to $1000 an oz, giving a value of $800,000.*
>
> *The gold is mixed with other gold and silver and manufactured into rings. Patchwork Bank has an all assets security which has been registered after Glennbank's security, and therefore ranks second. The rings are worth $2 million.*

Under this scenario Glennbank only has priority for $400,000, less than both the amount secured and the value of the assets contributed at the time of realisation.

Firms' Example 2

We had said that the amount owed to each farmer, and the price of wheat at the time of supply by each farmer, is different.

Our example was:

A wheat exporter buys wheat on retention of title terms from Farmer A (3,000 tonnes) and Farmer B (2,000 tonnes). The wheat is fungible, and mixed so that is becomes a mass of 5,000 tonnes. The price of wheat was different when supplied and added to the mass, and each farmer is owed different amounts because they had different payment terms.

We had proposed that if the mass is sold, then Farmer A should be able to have priority over, and first recourse to, 3/5 of the sale proceeds of the mass, and Farmer B should similarly have priority over and first recourse to 2/5 of the mass, regardless of the value at the time of contribution or the amount owed.

The Attorney General's Department commented on this example in their question on notice response dated 18 November 2009. With respect, we think that the result of the example we gave is clearly not as stated by the Attorney General's Department in that response, which seems to assume the ratio of amounts owed is the same as the wheat contributed.

To illustrate, say Farmer A (who had supplied 3/5 of the wheat) is owed $2000 and Farmer B (who had supplied 2/5) is owed $3000, and the wheat as a whole is now worth $4000 (because the price of wheat has gone down) and is sold on enforcement for that amount. Under subsection 102(2) the two farmers participate in the mass in the ratio of the secured amounts. Farmer A is entitled to 2/5 and Farmer B is entitled to 3/5 of the whole even though they had supplied wheat in the reverse proportion. That has the result that Farmer A receives $1600, and Farmer B receives $2400, even though the wheat supplied by them is worth $2,400 in the case of Farmer A, and $1600 in the case of Farmer B.

Example 2A

The example becomes even more dramatic if the secured parties are not farmers with PMSIs in wheat but financiers with security interests over respective contributions of gold.

> *Say, instead of Farmer A, there is Bank A who is owed $10,000 and had a security interest in 3/5 of the gold before commingling (and other assets), and instead of Farmer B. there is Bank B that is owed $90,000, and had a security interest in 2/5 of the gold before commingling (and security over other assets), and before commingling their gold was worth $135,000 and $90,000 respectively, but on enforcement the mass was worth $50,000 in total (so that the contributions at those values are worth $30,000 and $20,000).*

In that case Bank A recovers $5,000, and Bank B $45,000. Bank B receives a windfall.

In each case the result would be radically different if the wheat or gold had not been mixed.

It is hard get past the basic proposition that the financiers of two separate loads of wheat or gold will be able to realise their securities for up to the value of their respective loads at the time of realisation, as long as the loads are kept separate. Why should they risk loss (and others make a windfall gain) just because the two loads get mixed together?

Fungible goods

We think that this principle in particular is something that is easy to understand and easy to draft. It is not complex.

The proposition is simply that contributors of fungible goods to a mass should participate according to the respective goods contributed to the mass. It should not matter who is owed what in apportioning priority, or what the price was at the time of commingling. The mass is divisible, the proceeds of realisation on enforcement are divisible, and they should be divided according to the contribution to the mass.

We are suggesting that there be a special provision that governs what happens with commingled fungible goods. We think we should take the opportunity to improve on foreign models, and this would be a clear and easy improvement. That would be an opportunity for Australia to have a significant improvement on other jurisdictions, and a valuable one in an economy in which commodities are so important. Of course, the principles do not only apply to commodities, examples in previous cases in the case law include common stores of bottles of wine and gold coins. The principle could be extended to fungible intangibles.

Non-fungible goods

The principles that should apply to non-fungible goods are more complex, and may be open to debate, but it seems to us that the principles that have been applied in the drafting of sections 101 and 102 are not the appropriate ones, as is demonstrated in our examples 1 and 1A, and again the opportunity should be taken to fix them up. A fairer proposition for section 101 would be to look at the value of the goods at the time of realisation, not at the time of commingling.

That preserves the value of the security that had been taken over goods and would have been the value had the goods remained separate. It also prevents the other unfairness that can arise to subsequent secured creditors if a secured creditor has contributed goods which have significantly declined in value after commingling. That would apply equally to gold used in rings, to resin or woodchips used in chipboard, and to wheat used in bread (though in the latter cases there is unlikely to be any difference between value as at commingling and value as at realisation).

Section 101 limits priority to an historical figure which may have little relevance to the current value at the time of realisation.

Section 102 again has arbitrary results because it looks at the value of the secured obligation, rather than the value of the security. We suggest that a more reasonable principle in section 102 would be to divide up the proceeds according to the respective values of the goods contributed as at the time of realisation.

We cannot see the policy reason for limiting priority to an historical value or, when priorities are equal, dividing proceeds according to amounts secured rather than goods supplied.

Supplementary Submission provided by the Attorney-General's Department

Inquiry into the PPS (Consequential Amendments) Bill 2009 – Question on Notice

On 16 November 2009, Senator Crossin asked the Department the following questions on notice:

> Allens Arthur Robinson, Blake Dawson, Freehills and Mallesons Stephen Jacques have provided further information about their view of the operation of clauses 101 and 102 of the PPS Bill (reply to a question on notice provided 17 November 2009 http://www.aph.gov.au/senate/committee/legcon_ctte/pps_consequential/submissions.htm).
>
> Does the department agree that, in the example provided about Glenn's Gold Emporium, the result is not a commercially balanced outcome? In light of the view of the four law firms about the operation of clause 101, could the department provide further information about the policy justification for it?
>
> Could the department also provide information about the policy justification for clause 102?

Allens Arthur Robinson, Blake Dawson, Freehills and Mallesons Stephen Jacques ('the law firms') have suggested that the priority amount for the purposes of clause 101 should be determined by reference to the value of the relevant goods from time to time, rather than at the time the goods were commingled. The Department considers that the law firms' suggestion is not supported by the examples they provided.

Law firms' example 1

The law firms provided the following example in support of their suggestion:

> Glenn's Gold Emporium is a wholesale supplier of gold to the jewellery manufacturing market. It supplies gold on retention of title terms, and registers its security interests in accordance with the Act.
>
> A small but important customer of Glenn's Gold Emporium is an up-and coming boutique producer of reproduction antique rings, Patchworks. Glenn's Gold Emporium sells $100 of gold to Patchworks.
>
> Patchworks also maintains a number of banking facilities with Bobbin Bank. Patchworks has not given Bobbin Bank an all-assets security, but instead has given Bobbin Bank a security interest over all its stock of rings. Bobbin Bank has also perfected its security interest over the rings by registration.
>
> The gold price is notoriously volatile, and shortly after the sale of gold by Glenn's Gold Emporium to Patchworks, the price goes into a slump. Glenn's Gold Emporium is still owed $100 by Patchworks, but the value of the gold that it sold

has now dropped to $80. This happens to still be the price on the day on which Patchworks uses the gold to make some rings. As a continuation of the price volatility, the slump reverses itself a few days later, and the gold price recovers to its previous level.

Before Patchworks uses the gold to make rings, Glenn's Gold Emporium clearly has priority, and for its full $100.

Under clause 99 of the PPS Bill, Glenn's Gold Emporium's security interest in the gold continues into the ring. Because of the vagaries of the world gold price and the coincidental timing at which Patchworks used that gold to make some rings, however, its priority under clause 101 is limited to $80, even though Glenn's Gold Emporium is owed $100 and the current market value of the gold in the rings is now back at $100 as well.

Clause 99 of the Bill provides as follows (so far as is relevant):

99 Continuation of security interests in goods that become processed or commingled

(1) A security interest in goods that subsequently become part of a product or mass continues in the product or mass if the goods are so manufactured, processed, assembled or commingled that their identity is lost in the product or mass.

Three conditions must be satisfied before section 99 will apply:

(a) there must be a security interest in goods,

(b) the good must become part of a product or mass, and

(c) the goods must be so manufactured, processed, assembled or commingled that their identity is lost in the product or mass.

When these circumstances exist, the security interest in the goods continues in the product or mass.

In the example provided by the law firms, the first two conditions are satisfied, that is:

(a) there is a security interest in the gold supplied by Glenn’s Gold Emporium to Patchworks, and

(b) the gold becomes part of a product (that is, the rings manufactured by Patchworks).

However, the gold supplied by Glenn’s Gold Emporium has not been so manufactured, processed, assembled or commingled that its identity is lost in the product or mass (that is, the third condition is not satisfied). All of the gold in the rings manufactured by Patchworks is traceable to the gold supplied by Glenn’s Gold Emporium. Because of this, clause 99 does not apply to the scenario provided by the law firms.

The Department considers that the security interest in the gold granted by Patchworks to Glenn's Gold Emporium would continue in the gold despite the gold being manufactured into the rings. The gold is the same collateral despite having been manufactured into rings. To use an analogy, a security interest in a pile of sand would continue in all of the sand if the pile were divided into two piles of sand (without recourse to clause 99 of the Bill).

If Patchworks were in default under the security agreement, Glenn's Gold Emporium would be able to seize and dispose of the rings with a view to realising the amount owed to it (see Part 4.3 of the Bill). This assumes that Glenn's Gold Emporium has not contracted out of these rights (see clause 115 of the Bill). The Department understands that this is the outcome favoured by the law firms.

Law firms' example 2

The law firms have also provided the following example in support of their suggestion:

> A wheat exporter buys wheat on retention of title terms from Farmer A (3,000 tonnes) and Farmer B (2000 tonnes). The wheat is fungible, and mixed so that it becomes a mass of 5000 tonnes. The price of wheat was different when supplied and added to the mass, and each farmer is owed different amounts because they had different payment terms.

They have proposed that:

> If the mass is sold, then Farmer A should be able to have priority over, and first recourse to, 3/5 of the sale proceeds of the mass, and Farmer B should similarly have priority over and first recourse to B 2/5 of the mass, regardless of the value at the time of contribution or the amount owed.

The Bill as drafted would deliver the result suggested by the law firms in most situations as the following examples illustrate. The examples assume that the wheat was initially held separately by the wheat exporter and later mixed.

AGD example 1

If the price of wheat has fallen below that purchased from both Farmer A and Farmer B, the Bill will require the amount realised on the sale of the wheat to be paid 3/5th to Farmer A and 2/5th to Farmer B. This is the result suggested by the law firms.

AGD example 2

If the price of wheat has fallen to below that owed to Farmer A (but not that owed to Farmer B), the wheat exporter could sell 2,000 tonnes of wheat, pay out Farmer B and keep the profit. Farmer A would be entitled to enforce its security interest against the remaining 3,000 tonnes of wheat. This is the result suggested by the law firms: as each farmer has been paid out of the proportion of the wheat supplied by them.

AGD example 3

Similarly, if the price of wheat has fallen below that owed to Farmer B (but not that owed to Farmer A), the wheat exporter could sell 3,000 tonnes of wheat, pay out Farmer A and keep the profit. Farmer B would be entitled to enforce its security interest against the remaining 2,000 tonnes of wheat. This is the result suggested by the law firms: as each farmer has been paid out of the proportion of the wheat supplied by them.

AGD example 4

If the price of wheat has not changed since it was mixed, or has increased, the wheat exporter would in the ordinary course of its business sell all the wheat and pay out Farmer A and Farmer B the amounts they are owed. This is the result suggested by the law firms: as each farmer has been paid out of the proportion of the wheat supplied by them.

If the price of the wheat has not risen to the amount owed to Farmer A, Farmer A may nevertheless benefit by being paid out of profit made by the wheat exporter on the sale of the wheat supplied by Farmer B. Farmer A would therefore be better off than under the law firms' suggestion.

A scenario in which the law firms' suggestion may change the outcome delivered by the Bill is described in the following example.

AGD example 5

The law firms' suggestion may change the outcome if the price of wheat fell after it was purchased from Farmer A, rose after the wheat supplied by Farmer A was mixed with the wheat supplied by Farmer B (but not to the amount owed to Farmer A), and Farmer A enforced its security agreement against the wheat exporter.

Under the Bill, Farmer A would not benefit from any increase in the value of the wheat after it was mixed (clause 102(4)).

The law firms have suggested, in effect, that Farmer A should benefit from any increase in the value of the wheat after it was mixed.

Clauses 101 and 102

The Committee's March 2009 report on *Exposure draft of the Personal Property Securities Bill 2008* included the following comments:

> 4.13 One of the examples given of unnecessary length in a provision was that of sections relating to a 'commingling' of goods question. One overseas model addresses the issue in six lines of text, one in 40 lines of text, and the Australian draft bill in approximately 112 lines of text covering four and a half pages.

> 4.14 Again, it is a question of policy as to the appropriate balance to be struck between the two goals of certainty and simplicity. The committee agrees that it is important to ask the question generated by Professor Duggan's submission – are the benefits of greater drafting precision worth the cost?
>
> 4.15 This is another area in which the committee's view is that too much weight has been given to certainty at the expense of comprehensibility.

The Committee made the following recommendation at paragraph 4.19 of its report:

> 4.19 The committee strongly recommends that the Department reconsiders the balance between certainty of the law and the accessibility of the provisions with a view to:
>
> - using overseas provisions as often as possible to allow overseas experience to provide guidance for the Australian model.

The Government accepted the Committee’s recommendation.

The provisions in the Bill relating to commingling were amended so that they now reflect as closely as possible the provisions in the New Zealand Personal Property Securities Act 1999. As outlined above, the provisions drawn from New Zealand achieve the outcome sought by the law firms in most circumstances.

While it would be possible to amend the Bill to include a special provision achieving the outcome sought by the law firms when fungible goods are mixed, the price falls before the goods are mixed, but rises after the goods are mixed, this would add to the complexity of the Bill. It would represent a departure from the overseas models and reduce the capacity for overseas experience to provide guidance for those working with the Australian legislation.

Accepting the law firms’ suggestion may also result in the need to decide difficult questions of fact.

For example, Farmer A and Farmer B each supply 10 containers of grapes to a winemaker. It is not possible to work out which farmer supplied any particular container of grapes held by the winemaker. Should Farmer A be able to argue that the special rule should apply because its grapes are identical to the grapes supplied by Farmer B? Would it matter that the winemaker intended to mix all the grapes into the same barrels of wine? Would it matter if another winemaker would not mix all the grapes into the same barrels of wine? Alternatively, should Farmer B and the winemaker be able to argue that Farmer B’s grapes are sweeter than those supplied by Farmer A, and that because of this the special commingling rule should not apply? The court would need to decide whether the grapes supplied by the 2 farmers were sufficiently similar as to be substitutes, and so fungible, with the result that the special fungibles commingling rule would apply.

Even if the court decides that the proposed special fungibles commingling rule should apply because the grapes supplied by the 2 farmers are perfect substitutes, this might in some circumstances result in an outcome that is not commercially balanced. For example, the winemaker might have incurred considerable expense in transporting, storing and otherwise dealing with the grapes prior to the farmers making their claim. Would it always be commercially balanced to give priority to the grapegrowers over the expectations of the haulage and storage companies that they would also be paid out of the moneys realised from the grapes?

Non-fungible goods

In addition, it should be noted that the existing provisions of the Bill also apply in scenarios involving the commingling of goods that are not fungible.

For example, Farmer A might supply flour to a baker, and Farmer B might supply eggs to a baker. The baker uses the eggs to manufacture bread. The value of the bread may be greater than the sum of the value of the flour and the eggs. Under the Bill, the amount that may be claimed by the farmers is limited to the value of the flour and the eggs on the day that the bread is made. This outcome recognises that there may be others who also have a claim to the bread because they have contributed to the increase in the value (for example, the owner of the recipe used to make the bread, the electricity or gas supplier, and the lessor of equipment used in the bakery).

It may not be a commercially balanced outcome to give the supplier of non-fungible goods priority over any increase in the value of the goods after the commingling occurs when there are claims made by others who have also contributed to the increase in the value of goods.