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Reform of Australia’s Personal Property Securities Law

Introduction

Following the lead of other jurisdictions, including the United States, Canada and New Zealand, the Commonwealth Government is pressing ahead with proposed new legislation that will revamp the law relating to security interests over personal property. If passed, the Personal Property Securities Bill 2008 (Cth) (**Bill**) will impact all businesses by creating a national set of laws for the registration of security interests in personal property. Under the proposed laws, a failure to register a security interest can have severe consequences. Therefore, companies will need to be aware of how these changes will affect their business.

Personal property security reform has been a policy issue for some time. In May 2007, the Commonwealth Government announced that it would spend \$113.3 million over five years to harmonise Australia’s personal property security laws in one Commonwealth Act and develop a single national online register of personal property security interests. The Attorney-General at the time, Philip Ruddock, claimed that “[p]ersonal property securities reform will reduce red-tape for businesses and lead to cheaper finance, more competition in the financial services sector and a reduction in legal disputes”. On 10 November 2008, an exposure draft of the Bill was released by the Attorney-General. The Bill essentially intends to remove the current limitations on the use of personal property as security for loans and thereby assist businesses raise capital. The Bill will effectively replace over 40 current personal property registers operated by, or on behalf of, the Commonwealth, States and Territories with a single register known as the “Personal Property Securities Register”.

Definition of “personal property”

The definition of “personal property” in the Bill captures all property other than land and interests in tangible property that is affixed to land. Personal property will extend to both tangible and intangible property, including motor vehicles, boats, machinery and equipment, crops, shares, intellectual property, receivables and contract rights. Under the Bill, a person will be able to register their security interest in personal property in the Personal Property Securities Register.

What is a “security interest”?

The term “security interest” is defined in the Bill as “*an interest or right in relation to personal property provided for by a transaction that in substance secures payment or*

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performance of an obligation (without regard to the form of the transaction or the person who has title to the property)". For example, a security interest can include an interest or right in relation to personal property provided by a fixed and/or floating charge, a chattel mortgage, a hire purchase agreement, a consignment or a lease of personal property.

It is important to note that the Bill takes an "in substance" approach in defining "security interest". Accordingly, a transaction may bring about a security interest notwithstanding the title, form, structure, subject matter or jurisdiction of the transaction.

Certain interests in personal property will also be deemed to be a security interest for the purposes of the Bill, whether or not the transaction concerned secures payment or performance of an obligation. These include interests or rights of a:

- (a) transferee in a transfer of an account or chattel paper (e.g. a monetary obligation);
- (b) lessor or bailor under a "PPS Lease". A PPS Lease is generally a lease or bailment of tangible property for a term of more than one year; and
- (c) consignor under a commercial consignment.

These deeming provisions are intended to prevent debtors from structuring transaction to avoid the application of the law.

Security Interest must *attach* to Personal Property

A security interest will be enforceable against the grantor in respect of personal property only if the security interest has *attached* to the grantor's particular interest or right in that personal property (**Rights**). Generally, a security interest will attach to Rights when:

- (a) either the grantor has:
 - (i) Rights in the property; or
 - (ii) the power to transfer Rights to the secured party; and
- (b) either:
 - (i) value is given by the secured party for the security interest in the Rights; or
 - (ii) the grantor does an act by which the security interest in the Rights is created, arises or is provided for.

A security interest must also attach to the Rights in personal property before it is enforceable against a third party. For a security agreement to be enforceable against a third party the personal property must also be in the possession or control of the secured party (or by another person acting on behalf of the secured party e.g. a duly appointed security agent) or the security agreement must be in writing and clearly identify the secured property. An oral security agreement would not be enforceable against third parties, such as a liquidator, administrator or trustee in bankruptcy.

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A security agreement can provide that security attaches to Rights in particular personal property acquired by the grantor after the security agreement is entered into and can be used to secure a future advance.¹

Perfection of Security Interest

In order for a secured party to “perfect” its security interest in the collateral (i.e. personal property to which a security interest is attached), the security interest must have attached to the collateral and the secured party must have possession or control of the collateral or the collateral must be registered.

In certain cases, a security interest will automatically be perfected for a limited period of time, referred to in the Bill as “temporary perfection”. Temporary perfection may apply where the collateral is transferred from one grantor to another, converted into proceeds or moved to Australia from overseas.

The concept of perfecting a security interest is critical as, subject to certain exceptions, once a security interest is “perfected”, the secured party will be able to enforce the security interest against third parties. For instance, under current law, if a lessor leases goods to a lessee and the lessee becomes insolvent, the lessor would normally be entitled to immediately repossess those goods. However, under the Bill, the lessor would be required to register its security interest over those goods. If the lessor has failed to register its security interest at a time when the lessee becomes insolvent, the lessor would then have to claim, along side other unsecured creditors, the amount owed by the lessee to the lessor. In these circumstances, the lessor’s rights of repossession of the relevant goods would be subject to any higher priority security interest (e.g. a registered security interest), even if that higher priority security interest is created *after* the lessor’s security interest was created. Similarly, a person with an unperfected security interest over Rights in goods held by the grantor of that security interest, may rank behind a person who has a perfected security interest over those same goods, notwithstanding that the first mentioned person has legal title to those goods.

Acquiring personal property free from a security interest

The Bill provides a number of cases where a transferee of secured personal property will acquire a Right in that personal property that is free from a pre-existing security interest over that personal property. These include where:

- the pre-existing security interest in that personal property is unperfected;
- that personal property is acquired by the transferee in the ordinary course of the transferor’s business of dealing with property of that kind;
- that personal property is acquired by the transferee with the intention to use it predominately for personal, domestic or household purposes and the value given for the transferee’s interest is not more than \$5,000 (or a greater amount prescribed by the regulations); or
- that personal property is:

¹ For the sake of clarity, future references to a security interest in personal property or collateral are intended to mean, a security interest in the Rights of a grantor in that personal property or collateral.

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- Australian or any foreign currency;
- an investment instrument and the transferee's interest is acquired by a consensual transaction. An investment instrument includes a share, debenture, derivative, foreign exchange contract, option, unit or financial product; or
- a motor vehicle.

Most of the above exceptions require that the transferee of the relevant personal property has no knowledge of the pre-existing security interest. In this regard, a person ("first person") will be deemed to have knowledge of a pre-existing security interest if the first person:

- (a) has actual knowledge of that security interest; or
- (b) would have had actual knowledge of that security interest if the first person made inquiries that would:
 - (i) ordinarily have been made by an honest and prudent person in the first person's situation; or
 - (ii) be made by an honest and prudent person with the first person's actual knowledge in the first person's situation.

Priorities

The Bill sets out rules for determining who has priority where more than one person has a security interest in the same collateral. A summary of these rules is set out below.

- A person who has a perfected security interest in collateral has priority over a person who has an unperfected security interest in that collateral.
- A security interest in collateral that is perfected by control has priority over a security interest in that collateral that is perfected by another means (including registration). Only certain property is "controllable" property, e.g. an investment instrument, an ADI account.
- Where two or more security interests in collateral are perfected by control, the security interest that was perfected first in time by control, takes priority.
- Where two or more security interests in collateral are perfected, but not by control, the security interest that was perfected first in time, whether by registration, possession or that was temporarily perfected, takes priority.
- Priority between unperfected security interests in the same collateral is determined by the chronological order of attachment of the security interests.

Under the provisions of the Bill, superior priority is granted to so-called "purchase money security interests" (**PMSI**). The main examples of a PMSI include a security interest taken in collateral by:

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- (a) a seller to the extent that it secures the obligation to pay all or part of the collateral's purchase price; or
- (b) a third party who gives value for the purpose of enabling the grantor of the security interest to acquire a Right in the collateral.

Subject to perfection and notice requirements, a PMSI will generally take priority over any other earlier or **future** security interest in the same collateral (other than where the subsequent security interest is perfected by control). The "super" priority granted to PMSIs will represent a significant departure from current law. Whilst such super priority will help protect the interests of sellers, lessors and financiers in property which they have assisted a grantor in acquiring, it will materially reduce the utility to a financier of pre-existing fixed and floating charges. Often a general financier will register a fixed and floating charge over the present and **future** assets of a borrower to whom that general financier provides funds. The higher priority given to the holder of a subsequently registered PMSI will, from the earlier financier's perspective, significantly limit the value of its charge insofar as it purports to create a security interest in property of the grantor acquired *after* the giving of the charge. A possible solution would be for a general financier to impose a "negative pledge" type obligation on the grantor not to grant any PMSIs subsequent to giving the charge. However, in the event of a breach of that provision, the general financier's remedy would be in damages arising from a breach of contract, rather than being able to enforce the charge in priority to the Rights accorded to the holder of the PMSI.

Enforcement

A secured party, in exercising its rights and remedies, will only be permitted to deal with the collateral to the same extent as the grantor would be entitled to deal with it. A secured party will be able to seize collateral, by any method permitted by law, if the debtor is in default under a security agreement. A secured party wishing to seize collateral must first give notice to the grantor and, if the collateral is a licence, then to either the licensor or the licensor's successor. Once collateral is seized, the secured party can either dispose or retain the collateral in accordance with the provisions set out in the Bill.

A secured party may enforce a security interest over collateral notwithstanding that another secured party has a higher ranking security interest over the same collateral. However, the lower ranking secured party must first give notice to other secured parties that have a higher priority and, in some cases, lower ranking parties e.g. where the secured party giving such notice proposes to retain the collateral. A higher ranking secured party will also have certain rights over a lower ranking secured party, including demanding possession of any seized collateral.

The parties to a security agreement that provides for a security interest in collateral that is not used predominantly for personal, domestic or household purposes may contract out of a number of the enforcement provisions in the Bill. However, those provisions will continue to apply to persons who are not parties to the security agreement.

The Bill provides that all rights, duties and obligations that arise under a security agreement or the Bill must be exercised or discharged honestly and in a commercially reasonable manner. This requirement extends to a secured party who wishes to enforce its security interest, whether against the grantor or third parties.

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Registration

The Personal Property Securities Register (**Register**) will, in respect of each registered security interest, include information about the secured party and the grantor, an address for service for the secured party, a description of the collateral, the period of registration, details of any subordination agreement and details of any amendments to the registration. Collateral will be secured from the moment a description of the collateral becomes available for search in the Register. The period of registration for consumer property will be 7 years (which can be extended) and commercial property will be able to be registered for an indefinite period of time.

The Government anticipates that registration will be the most commonly used method of perfecting a security interest for the purpose of establishing priority in enforcement and effectiveness in insolvency. However, as noted above, perfection of security interests by means of control will have priority over perfection of security interests by registration.

Review by Standing Committee

In November 2008, the Bill was referred for inquiry to the Standing Committee on Legal and Constitutional Affairs (**Standing Committee**). The Standing Committee released its report on 19 March 2009. Some of the key recommendations of the Standing Committee included, among others:

- simplifying the language, terminology and structure of the Bill;
- extending the commencement of the Bill from May 2010 to May 2011, for the Standing Committee's recommendations to be implemented;
- making provisions to protect the privacy of individuals; and
- improving the priority of an unperfected lessor as against unsecured or other unperfected interests in goods.

The Attorney-General has yet to comment on the recommendations of the Standing Committee.

Implications

If passed in its current form, the Bill will extensively reform Australia's law of security interests in personal property. The laws will affect a wide variety of commercial transactions, particularly for small to medium sized enterprises. As a practical consequence of this reform, it will be necessary for all businesses to:

- (a) ensure registration of security interests over any collateral;
- (b) ensure all security agreements are in writing;
- (c) if possible, take possession or control over any secured collateral;

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- (d) conduct searches of the Register when considering taking security over collateral or purchasing personal property to ensure there are no existing registered security interests;
- (e) amend and negotiate contracts to take account of the Bill, including considering whether it is appropriate to exclude the operation of certain enforcement provisions; and
- (f) ensure compliance with the requirements of the Bill in relation to enforcement of a security interest.

The next step for the Government will be to consider the Standing Committee's recommendations. Given the nature of the recommendations, it is possible that further amendments will be made to the Bill before it is debated in Parliament. In any event, it is likely that the Bill will be passed and businesses need to start preparing for the changes that the new laws will bring about.

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