Review of the Personal Property Securities Act 2009

CONSULTATION PAPER 2
Creation and perfection of security interests; taking free rules; priority rules; and other dealings in collateral
REVIEW OF THE PERSONAL PROPERTY SECURITIES ACT 2009
CONSULTATION PAPER NO. 2

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1. **INTRODUCTION**

1.1 **What this paper is about**

This is the second of a series of consultation papers that are being released in connection with the review of the operation of the *Personal Property Securities Act 2009* (the Act) that is being conducted in accordance with s 343 of the Act. The consultation papers were foreshadowed in the *Interim Report on the Review of the Personal Property Securities Act 2009* dated 31 July 2014, available online at [www.ag.gov.au/ppsareview](http://www.ag.gov.au/ppsareview).

This consultation paper considers issues regarding:

- the creation and perfection of security interests;
- the taking free rules;
- the priority rules; and
- other dealings in collateral.

This paper does not address questions that relate to the Register, even though the Register plays a key role in the perfection of security interests. The Register will be the subject of a later paper.

1.2 **Supporting materials**

This paper uses abbreviated terms for concepts or documents that are referred to frequently. A glossary of these terms can be found in Annexure A.

The Interim Report set out a number of principles to guide the process of assessing the merits of proposed amendments to the Act. For convenience, a copy of those principles is set out in Annexure B.
2. **ATTACHMENT**

2.1 **Requirements for attachment**

Section 19(1) of the Act states that a security interest is only enforceable against a grantor in respect of particular collateral if the security interest has "attached" to the collateral.

Section 19(2) sets out what is required for a security interest to attach to collateral. Section 19(2)(a) states that a security interest will only attach if, among other requirements:

(a) the grantor has rights in the collateral, or the power to transfer rights in the collateral to the secured party; ...

2.2 **Rights in the collateral**

The Act does not define what it means by a person having "rights" in collateral. It is clear that a person will have rights in collateral for the purposes of s 19 if they own it. It is less clear, however, in what other circumstances a person can have rights in collateral for the purposes of the section.

In the eyes of the general law, for example, a person who buys goods subject to a retention of title clause has only a right to possess the goods, and not an ownership interest in them, until they have paid the purchase price. Similarly, a lessee under a lease only has the right to possess the leased goods, not an ownership interest in them. Despite this, the Act clearly contemplates that a purchaser of goods subject to retention of title, or a lessee of goods, can have sufficient rights in the goods to support attachment of a security interest, at least in favour of the seller as lessor.

The Act endeavours to close this conceptual gap with s 19(5), which states:

(5) For the purposes of paragraph (2)(a), a grantor has rights in goods that are leased or bailed to the grantor under a PPS lease, consigned to the grantor, or sold to the grantor under a conditional sale agreement (including an agreement to sell subject to retention of title) when the grantor obtains possession of the goods.¹

While s 19(5) confirms that a grantor will have sufficient rights in the collateral to support attachment for the types of security interests listed in the section, however, it does not clearly cover all the types of security interests that could arise when a grantor has only a possessory interest in the collateral. For example, it does not clearly cover leases or hire-purchase agreements that are security interests under s 12(1) but are not within the definition of PPS lease in s 13.

Section 19(5) is based on a similar provision in the Canadian PPSAs² and the NZ PSA.³ Despite this, in my view s 19(5) should be amended to clarify that it applies to all security interests in favour of a secured party that owns the collateral, where the

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¹ Some commentators argue that s 19(5) is not the source of the grantor's rights in the collateral for the transactions listed in the section, and that it only regulates the timing of the attachment – see the discussion in S McCracken, Conceptualising the Rights of a Lessee under the Personal Property Securities Regime: The Challenge of 'New Learning' for Australian Lawyers (2011) 34(2) UNSWLJ 547, at pages 555 to 556.

² Eg Sask PPSA, s 12(2).

³ NZ PSA, s 40(3).
security interest is founded on the grantor’s possession of the collateral, rather than ownership.

A broader question is whether bare possession of personal property can be sufficient to enable the person in possession of the property to grant a security interest over that property to a third party as well, and not just back to the owner. The commentaries and case law in Canada and New Zealand are divided on this question.4

The “bare possession is enough” approach

Some commentators argue that bare possession can be sufficient rights in collateral to support attachment of a security interest. They accept however that this is subject to an important qualification, which is that the secured party only obtains a security interest in the defeasible possessory title of the person in possession. The security interest can be effective as against outsiders, but would be subject to the rights of the true owner.

It is not clear, however, that this line of analysis produces an appropriate outcome if the owner has also given security over the collateral, to a different secured party. In a competition between the security interests held by the two secured parties, common sense suggests that the owner’s secured party should win. If the security interest granted by the person in possession was perfected first, however, then that security interest would take priority. Also, if bare possession is sufficient to support attachment, it is not clear why s 19(5) is needed, or why it is limited to the transactions listed in the section.

The “bare possession is not enough” approach

The alternative approach is to argue that bare possession of collateral is not sufficient to enable the possessor to generally grant security over the collateral, and that bare possession of personal property should only be sufficient rights in the property for the person in possession to grant a security interest over that property back to the owner, by virtue of s 19(5). This would mean that a person would only be able to grant a security interest over collateral if:

- the person owns the collateral;
- the person has possession of the collateral, and it is granting the security interest back to the owner; or
- the person is treated by the Act as if it were the owner of the collateral, by virtue of being the grantor of another security interest over it.

It would follow from this that a person who is in possession of property on some other basis would only be able to grant a security interest over its possessory rights, not over the property itself. This approach is more nuanced, but arguably produces a more intuitive result.

I would be interested to hear the view of others on this.

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4 See B Whittaker, The Scope of ‘Rights in the Collateral’ in Section 19(2) of the PPSA – Can Bare Possession Support Attachment of a Security Interest? (2011) 34(2) UNSWLJ 524; and S McCracken, Conceptualising the Rights of a Lessee under the Personal Property Securities Regime: The Challenge of ‘New Learning’ for Australian Lawyers (2011) 34(2) UNSWLJ 547.
I am not proposing to recommend that the Act be amended to clarify the extent to which bare possession can support attachment of a security interest in favour of a person other than the owner. Rather, I propose to rely on the fact that any explanation of the issue that might be included in my final report may be extrinsic material of a type referred to in s 15AB(2)(b) of the Acts Interpretation Act 1901, and so available to assist in the interpretation of the Act.

Proposed recommendation 2.1:  That s 19(5) be amended to clarify that it applies to all security interests in favour of a secured party that owns the collateral, where the security interest is founded on the grantor’s possession of the collateral.

2.3 The power to transfer rights in the collateral to the secured party

Section 19(2)(a) states that a security interest can attach to collateral, even if the grantor does not have rights in the collateral, if the grantor has the power to transfer rights in the collateral to the secured party.

This additional wording can be found in the Canadian PPSAs and in Article 9, but not in the NZ PPSA.

It is not clear what this additional wording is intended to address. The Official Comments to Article 9 suggest that the language was included there because the alternative test for attachment (that the grantor has rights in the collateral) would only permit the grantor to give security over those rights (based on the nemo dat principle), rather than over the entire collateral. According to the Official Comments, the additional wording was designed to close that gap. It has also been suggested in the context of the Canadian PPSAs that the language is needed to facilitate the granting of security interests over intermediated securities.

It is not clear that either of these explanations is applicable in the context of the Act. It is clear from the Act that a grantor who has rights in personal property can grant a security interest over the entirety of that property, and not just those rights. This suggests that this additional language may be superfluous for the purposes of the Act. (This view is also supported by a leading Canadian commentary in relation to the Canadian PPSAs.) If that is correct, then the language is unnecessary and a source of potential confusion, and should be deleted.

Proposed recommendation 2.2: That s 19(2)(a) be amended to read:

"(a) the grantor has rights in the collateral; and"

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5 Eg Sask PPSA, s 12(1)(b).
6 Article 9, §9-203(b)(2).
7 Official Comment 6 to §9-203.
8 See, eg, Richard H McLaren, The 2011 Annotated Ontario Personal Property Security Act (Carswell, 2011) 140: 'The phrase “power to transfer rights in the collateral” permits the debtor to attach a security interest to a security entitlement in addition to directly holding securities'.
9 It has also been said that the additional language is necessary to enable a transferor of an account to make further transfers of the same account – see Understanding the Law of Secured Transactions, note 128.
10 Cuming Walsh & Wood, pages 249 to 250.
2.4 The need for a security agreement

One submission suggested that s 19 be expanded to confirm that a security interest will only attach if there is a valid security agreement in place between the grantor and the secured party.

I am not convinced that this is necessary. As the submission noted, this is implicit already, for example because s 12 says it is a requirement for a security interest that it arise under a "transaction". It is also difficult to see how a security interest could arise other than voluntarily or by operation of law, and security interests that arise by operation of law are excluded by ss 8(1)(b) and (c).

Section 19 currently allows a security interest to attach to collateral whether or not there is a security agreement in writing – that is, a security interest can attach to collateral under an oral security agreement. I do not take the submission as arguing that this should change. If s 19 were to be amended as suggested, the drafting would need to allow for both oral and written security agreements, and for unilateral grants of security such as by deed. I am not satisfied that the benefit that would be gained from this additional drafting would justify the effort involved, particularly as a focus of this review is to simplify the Act where appropriate, rather than add to its complexity.

**Proposed recommendation 2.3:** None at this stage, pending further consideration.
3. **ENFORCEABILITY AGAINST THIRD PARTIES**

3.1 **Section 18 – general rules about security agreements**

Sections 18(2) and (4) contain the following rules:

(2) A security agreement may provide for security interests in after-acquired property.

(4) A security agreement may provide for future advances.

Similar provisions are found in the Canadian PPSAs\(^\text{10}\) and the NZ PPSA.\(^\text{11}\)

It may have been that the points addressed in ss 18(2) and (4) were matters of uncertainty under prior Canadian law, and that it was helpful for that reason to clarify the situation by making specific provision for them in the Canadian PPSAs.\(^\text{12}\) They are however relatively self-evident under Australian law, and it may be that the Act could be simplified without adverse effect if they were deleted.

The expression "future advance" is used in only one other place in the Act (in addition to s 18(4)), in s 58. Section 58 is discussed in Section 6.5 below. If the recommendation in that Section is adopted, then the Act could be simplified by deleting the definition of "future advance" from s 10 as well.

**Proposed recommendation 2.4:** That ss 18(2) and (4), and the definition of "future advance" in s 10, be deleted.

3.2 **Security agreements – what needs to be evidenced by writing?**

Section 20 sets out what is required for a security interest to be enforceable against a third party in respect of particular collateral. To be enforceable against a third party, the security interest needs to be attached to the collateral. In addition, s 20(1)(b) states that one of the following needs to apply:

(b) (i) the secured party possesses the collateral;

(ii) the secured party has perfected the security interest by control;

(iii) a security agreement that provides for the security interest covers the collateral in accordance with subsection (2).

Section 20(2) describes what is required for a security agreement to "cover collateral". One of those requirements is that the security agreement be "evidenced by writing". It is not entirely clear from s 20(2), however, whether the writing needs to evidence the **existence** of the security agreement, or just its terms. This will not be an issue for most security agreements, as the writing for most security agreements will evidence both the terms of the agreement and the fact that it has been entered into. This is not always the case, however. It is not uncommon in commercial transactions for the proposed terms of an agreement to be set out in writing, but for the agreement itself to be entered into orally, or by some act of one of the parties that constitutes acceptance of the written offer. In arrangements for the supply of goods subject to a retention of title clause, for example, the retention of title clause and other contractual terms will

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\(^\text{10}\) Eg Sask PPSA, ss 13(1) and 14(1).

\(^\text{11}\) NZ PPSA, ss 43 and 71.

\(^\text{12}\) See Cuming Walsh & Wood, pages 260 to 261.
often be contained in a set of standard trading conditions that the supplier provides to the purchaser at the outset of the trading relationship. Those trading terms will set out the conditions that are to apply to any agreements that are subsequently entered into for the sale and purchase of specific goods, but will not themselves constitute the actual sale and purchase agreement.

The better interpretation of s 20(2) is that it only requires that the terms of the security agreement be evidenced by writing, not the fact that the agreement has been entered into. In my view, however, it would assist in the interpretation of the Act if this were made clearer.

3.3 **What terms of the security agreement does the writing need to evidence?**

A security agreement will normally contain provisions that address a range of issues. They can include:

- the identity of the parties
- the grant of the security interest
- the identity of the collateral
- enforcement triggers and remedies
- financial and operational undertakings.

If a security agreement includes all these matters, does s 20 require that they all be evidenced by writing?

Section 20 serves a similar purpose to the Statute of Frauds,¹³ in that it is designed to ensure that a secured party can only enforce its security interest against third parties if there is objective evidence of the existence of the security interest and of the collateral that is subject to it.¹⁴ If that is accepted as correct, then s 20 should only require that the writing evidence the terms of the security interest and the identity of the collateral, and not any other terms that also happen to be part of the security agreement as well.

3.4 **How should the collateral be described?**

Section 20(2)(b) also states that a security agreement will only cover collateral if:

(b) the writing evidencing the agreement contains:

(i) a description of the particular collateral, subject to subsections (4) and (5); or

(ii) a statement that a security interest is taken in all of the grantor’s present and after-acquired property; or

(iii) a statement that a security interest is taken in all of the grantor’s present and after-acquired property except specified items or classes of personal property.

These requirements are then expanded on by ss 20(4) and (5).

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¹⁴ Duggan & Brown, paragraph 4.25.
As a matter of general contract law, the terms of a security agreement need to be sufficiently certain to enable a court to identify exactly what property is subject to the security. At general law, a variety of sources may be drawn on to determine this – if the secured property is not expressly identified in the agreement, for example, it may be possible to identify the property through other means, outside the language of the agreement.

In contrast, s 20(2)(b) appears to require that the security agreement also describe the collateral in the manner described in the section. It is not clear why this is necessary.

As mentioned above, the intention behind s 20 is to ensure that the writing provides evidence of the existence of the security interest and of what the collateral is. However, s 20(2)(b) will not necessarily achieve this, as the writing only needs to contain a "description" of the collateral, and the term "description" is defined in s 10 in a manner that only requires the security agreement to identify the class of property that the collateral belongs to, not the precise collateral itself.

It is arguable that little is gained by the additional documentary requirements in s 20(2)(b). An alternative approach could be to simply follow the requirements of the general law, and only require that the description of the collateral in the writing be sufficient to enable the collateral to be identified, including where appropriate through resort to extrinsic evidence. This would be consistent with the approach taken in at least one Canadian jurisdiction, Ontario.15

3.5 **Proposed recommendation - Sections 3.2 to 3.4**

The combined effects of the changes discussed in Sections 3.2 to 3.4 could allow s 20(2) to be recast along these lines (and for ss 20(4) and (5) to be deleted):

(2) (a) A security agreement covers collateral in accordance with this subsection if the items described in paragraph (b) are evidenced by writing that is:

(i) signed by the grantor (see subsection (3)); or

(ii) adopted or accepted by the grantor by an act, or omission, that reasonably appears to be done with the intention of adopting or accepting the writing.

(b) The items referred to in paragraph (a) are:

(i) the terms of the security interest that is provided for by the security agreement; and

(ii) a description of the collateral that is sufficient to enable it to be identified.

**Proposed recommendation 2.5:** That s 20(2) be recast along the lines set out above, and that ss 20(4) and (5) be deleted.

3.6 **Situation where collateral is transferred**

If a grantor transfers collateral that is subject to a security interest and the security interest remains attached to the collateral in the hands of the transferee, the Act treats the transferee of the collateral as having become the grantor of the security interest in

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15 Ontario PPSA, s 11(2)(a)(i).
place of the original grantor. This is implicit, for example, in s 34, and is made explicit by paragraph (e) of the definition of "grantor" in s 10, and by the Note to s 166.

One submission pointed out that it is not clear from s 20(2) whether the security interest will only continue to be enforceable against a third party after the transfer if the transferee enters into a fresh security agreement with the transferor. It would not be appropriate to require this. The original security agreement will be sufficient to satisfy the evidentiary function behind s 20 (see Section 3.2), and there is no need to require the secured party to enter into a fresh agreement with the transferee, even assuming it could convince the transferee to do so. I agree that it would be useful to amend s 20 to clarify this.

**Proposed recommendation 2.6**: That s 20 be amended to make it clear that only the original grantor of a security interest over collateral needs to comply with s 20(2), not a person who becomes the grantor as the result of the collateral being transferred to it.
4. PERFECTION

4.1 Introduction

The Act provides five ways in which a security interest can be perfected over collateral. If the security interest has attached to the collateral and is enforceable against a third party, it can be perfected by any of registration, possession or (for certain types of collateral) control. These modes of perfection all require the secured party do something, in order to make its security interest perfected for the purposes of the Act.\(^\text{16}\) A security interest may also be perfected, either temporarily or permanently, by force of a provision to that effect in the Act. These additional modes of perfection are automatic, and do not require that any particular action be taken by the secured party.

A later paper will consider issues relating to perfection by registration, and in particular the operation of the Register. This Section 4 considers issues in relation to the other modes of perfection.

4.2 Perfection by possession

4.2.1 Seizure or repossession

The three main modes of perfection over collateral (registration, possession and control) all have a publicity objective, in that they function as a form of notice to outsiders that the personal property in question could be subject to a security interest.\(^\text{17}\) If a secured party perfects its security interest by taking possession of the collateral, for example, the fact that the secured party rather than the grantor has possession should serve as a warning to others that the grantor may not have clear title.

Section 21(2)(b) provides however that a secured party's possession of collateral will not be sufficient to perfect its security interest if the possession is as a result of seizure or repossession. The point is restated in s 123(4) as well. This limitation on the extent to which possession can perfect a security interest is different to the requirements in s 20 for the security agreement to be enforceable against a third party, where it appears that possession as a result of seizure or repossession will suffice.\(^\text{18}\) The position under s 21(2)(b) reflects the approach taken by the NZ PPSA,\(^\text{19}\) and by all of the Canadian PPSAs\(^\text{20}\) other than Ontario (which takes the opposite approach)\(^\text{21}\).

A number of arguments have been advanced in support of the approach taken in the NZ PPSA and the majority approach in the Canadian PPSAs. The principal argument is that the surrender of possession by the grantor to the secured party is intended to be a voluntary act of the debtor, akin to the concept of a pledge. Seizure or repossession, by contrast, is involuntary (at least as far as the grantor is concerned). It has also

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\(^\text{16}\) There is one exception to this – see Section 4.3.5.

\(^\text{17}\) See the discussion of this in Consultation Paper No. 1, Section 2.1.

\(^\text{18}\) Although some commentators read a similar limitation into the NZ equivalent of s 20(2)(b)(i) as well – see Gedye Cuming & Wood, para 36.2.

\(^\text{19}\) NZ PPSA, s 41(1)(b)(ii).

\(^\text{20}\) Eg Sask PPSA, s 24(1).

\(^\text{21}\) Ontario PPSA, s 22(1).
been suggested that allowing seizure or repossession to perfect a security interest could give rise to some other, more practical challenges.\textsuperscript{22}

The Ontario approach, in contrast, focuses on the role of perfection as a means of notifying outsiders that the secured party may have a security interest in the collateral. The Ontario approach takes the view that this publicity objective is achieved by possession that is the result of seizure or repossession, at least as effectively as it is achieved by possession that is taken before default.

In my view, there is considerable merit in the Ontario approach. If a secured party has taken possession of collateral, that will serve as notice to others of the fact that the secured party may have security over the collateral, just as effectively as possession would if it were taken by the secured party at an earlier point in time. The Act permits a secured party to perfect by registration at any time, and I do not see why the same flexibility should not be available to a secured party who wants to perfect by possession instead. It would also simplify the Act if the same approach was used in both ss 20 and 21 on this point.

**Proposed recommendation 2.7**: That the language "(other than possession as a result of seizure or repossession)" be deleted from s 21(2)(b).

4.2.2 **Bearer investment instruments**

Section 24(6)(b) states that a person will only be taken to have possession of an investment instrument that is evidenced by a certificate if, among other requirements:

\[
\text{(b) a transfer of the investment instrument may be registered on books maintained for that purpose by or on behalf of the issuer (or the certificate states that a transfer of the instrument may be so registered); ...}
\]

One submission pointed out that this seems to suggest that it may not be possible to perfect by possession over a bearer investment instrument. This is unlikely to have been the intent,\textsuperscript{23} but it would helpful to clarify the intent of the Act, and to remove the uncertainty.

**Proposed recommendation 2.8**: That s 24(6) be amended to clarify that it only applies to a security interest over registrable investment instruments.

4.3 **Perfection by control**

4.3.1 **Introduction**

Section 21 provides that a security interest will be perfected over the following types of collateral, listed in s 21(2)(c), if the secured party has "control" of the collateral:

\[
\begin{align*}
\text{(i) } & \text{an ADI account;} \\
\text{(ii) } & \text{an intermediated security;} \\
\text{(iii) } & \text{an investment instrument;} \\
\text{(iv) } & \text{a negotiable instrument that is not evidenced by a certificate;}
\end{align*}
\]

\textsuperscript{22} Cuming Walsh & Wood, page 310.

\textsuperscript{23} See Duggan & Brown, para 5.20.
(v) a right evidenced by a letter of credit that states that the letter of credit must be presented on claiming payment or requiring the performance of an obligation;

(vi) satellites and other space objects.

It can be seen that these categories of collateral, with the exception of satellites and other space objects, are all intangibles. This means that it is not possible to perfect over them by possession.\(^2^4\) The notion of perfection by control operates in many respects as a functional equivalent to perfection by possession, for the types of property listed in the section.

Perfection by control is also a feature of the Canadian PPSAs,\(^2^5\) and of Article 9.\(^2^6\) Perfected by control is not provided for, however, in the NZ PPSA.

When assessing the rules for perfection by control, it is important to remember that perfection of a security interest is intended to serve a publicity function – that is, to provide third parties with an opportunity to become aware that a secured party might have a security interest in particular collateral. Perfection by possession does this.\(^2^7\) It also follows from the nature of possession that only one secured party can be perfected by possession over an item of collateral at any given time. These factors assist perfection by possession to serve its publicity function. As will be seen from the discussion below, however, perfection by control does not necessarily deliver an equivalent outcome.

### 4.3.2 Intermediated securities

#### 4.3.2.1 Introduction

The concept of an intermediated security was not known to Australian law before the Act. The term derives from two international conventions, the Hague Conference Convention for the Law Applicable to Certain Rights in Respect of Securities held with an Intermediary, and the UNIDROIT Convention on Substantive Rules for Intermediated Securities.

Traditionally, an investor in a financial asset had a direct legal relationship with the issuer of the asset. In the case of a share, for example, the shareholder was registered as the owner of the share in the issuing company’s share register. If the shareholder wanted to transfer the share, it would execute a transfer form and lodge it (together with the share certificate) with the company. The company would then issue a fresh share certificate in the name of the transferee.

This is an inefficient method of dealing in a financial asset, and is said to have become increasingly unmanageable in the United States in the 1960s as a result of growth in the volume and speed of trading in securities. Technology and the state of the law at that time apparently did not allow this problem to be solved through the use of uncertificated securities along the lines of our CHESS system (discussed further below). Instead, market participants turned to a solution that relies on the electronic systems that are maintained by brokers and other intermediaries. Under that solution, individual investors are not registered on an issuing company’s books as the holder of

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\(^{2^4}\) As a practical matter, it may be difficult to perfect by possession over satellites and other space objects as well.

\(^{2^5}\) Apart from Prince Edward Island. See, for example, Sask PPSA, s 24.1.

\(^{2^6}\) Article 9, § 9-314.

\(^{2^7}\) Particularly as ss 24(1) and (2) make it clear that the secured party needs to have actual possession of the collateral, to the exclusion of the grantor.
rather elusive. It is defined in s 15(1) in these terms:

1. An intermediated security is the rights of a person in whose name an intermediary maintains a securities account.

Section 15 does not explain what it means by the "rights" of the holder of an intermediated security. They would generally be understood to be either or both of the holder's contractual rights against the intermediary, and a beneficial interest in the pool of the securities that the intermediary holds for that person and the intermediary's other customers. Unlike the position in the United States and Canada (discussed in the next Section), though, Australia does not have a legislative framework that clarifies this and other related questions, at least at this stage.

4.3.2.2 Have we jumped the gun?

As just discussed, the intermediated system for holding and trading financial assets was developed in the United States. United States law accommodates the intermediated holding system with a comprehensive set of rules, contained in Article 8 of the UCC. Article 8 defines the nature of an investor's interest in financial assets held through an intermediary (referred to in Article 8 as a "securities entitlement"), and introduces the concept of "control" as a mechanism that enables a purchaser of an interest in a financial asset (called a "protected purchaser") to be confident that it can acquire title to the interest free of adverse claims. Article 9 then draws on the legislative framework in Article 8 to provide specific rules for security interests over securities entitlements, including by allowing a secured party to perfect by control.

Canada has followed a similar path. All the Canadian provinces\(^28\) have enacted a Securities Transfer Act that follows very closely the content of Article 8 of the UCC, and

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\(^{28}\) Other than Prince Edward Island.
have made corresponding consequential amendments to their Canadian PPSAs, including to incorporate a concept of perfection by control.

Australia does not have an equivalent of Article 8 of the UCC, or of the Canadian Securities Transfer Acts. As noted in the previous Section, Australia is also not yet party to either the Hague Securities Convention or the UNIDROIT Securities Convention. These factors make it appropriate to ask whether it may have been premature for the Act to include provisions to deal specifically with intermediated securities. I would be interested to hear views on this.

**Proposed recommendation 2.9:** *None at this stage, pending further consideration.*

4.3.2.3 **Are the options for perfecting by control appropriate?**

I have no doubt that it is convenient for a person who holds a security interest over an intermediated security to be able to perfect that security interest without needing to register a financing statement against the grantor. I can also accept that the option of perfecting a security interest over an intermediated security by control can facilitate the smooth operation of the markets on or through which interests in financial assets are traded. In those respects, the ability to perfect by control clearly has value.

It could be argued however that perfecting a security interest over an intermediated security by control, unlike perfection by registration or possession, does not necessarily deliver on the publicity objective, in that it does not necessarily warn third parties that the intermediated security may be encumbered. If perfection by control over intermediated securities is to be retained, there is merit in considering whether the methods by which this can be done should be amended in a way that is better able to put third parties on notice of the existence of the security interest that it perfects. For example, it might be appropriate to structure those methods in such a way that only one secured party at a time can be perfected by control (as is the case for security interests over tangible collateral that are perfected by possession). It might also be appropriate to structure them so that a secured party will only have control if it is able to ensure that the intermediated security cannot be dealt with without its consent, so that its perfection can serve more effectively as a notice to third parties of the potential existence of its security interest.

**Proposed recommendation 2.10:** *None at this stage, pending further consideration.*

4.3.2.4 **Can the concept of an intermediated security be simplified?**

The definition of “intermediated security” in s 15(1) is a combination of three concepts:

- the **rights** of a person,
- in whose name an **intermediary**, and
- maintains a **securities account**.

The likely meaning of the “rights” of the holder of the securities account was touched on in Section 4.3.2.1.

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29 Other than the civil law jurisdiction Quebec, which does not have a Canadian PPSA but has made corresponding changes to its equivalent legislation.
The term "intermediary" is defined in ss 15(2) to (6). It is quite a technical definition, and focusses not on the role performed by an entity, but rather on the nature of the licences that the entity holds. One submission suggested that this is not desirable, and that the requirement that the intermediary be licensed should be removed. That would be consistent with the approach taken under the UCC and in Canada. In those jurisdictions, however, the scope of the rules relating to intermediated securities is framed by the rules in Article 8 of the UCC or the Securities Transfer Acts, respectively, and there are no corresponding rules in Australia’s legal framework at present. This demonstrates again the difficulty of providing for intermediated securities in the Act, without the balance of the accompanying legal framework found in the United States and Canada.

The current approach to the definition of "intermediary" is however consistent with the UNIDROIT Securities Convention, which contemplates that a contracting state might want to limit the scope of the concept in this way.30

The expression "securities account" is also defined, in s 15(7). For the most part, it relies on a further term, "financial product". That term is defined in s 10, in this way:

**financial product:**

(a) for the purposes of the definition of investment instrument in this section—has the meaning given by the Corporations Act 2001; and

(b) for any other purposes—means any of the following, or an interest in any of the following, other than cash:

(i) shares;

(ii) bonds;

(iii) any other financial instrument;

(iv) any other financial asset.

It would make the Act more comprehensible and easier to work with if the concept of an intermediated security could be simplified. I would be interested to receive suggestions for this.

4.3.2.5 What if the intermediary is itself the secured party?

It is common for a custodian of financial assets to include a requirement in its trading terms for its customer to grant it a security interest (often called a lien) over all the assets that the customer holds through the custodian. This security interest is often expressed to be over the benefit of the customer's accounts with the custodian.

The ways in which a security interest can be perfected by control over an intermediated security are set out in s 26. Those methods of perfection all appear to assume that the secured party is a different person to the intermediary. This makes it unclear that the intermediary itself can perfect by control if it is also the secured party, and appears to suggest that it may only be able to perfect by registration.

I see no good reason why an intermediary should be any less able than other secured parties to perfect a security interest by control over intermediated securities that are held with it. Article 8 of the UCC and the Canadian Securities Transfer Acts do allow an

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30 UNIDROIT Securities Convention, Article 5(a).
intermediary to perfect by control, and even go on to deem that perfection to be automatic (similar to the position that an ADI enjoys when it has security over an ADI account with it – see Section 4.3.5 below).

**Proposed recommendation 2.11:** That it be made clear, if the concept of perfection by control over intermediated securities is retained, that the intermediary itself can also perfect a security interest by control over intermediated securities held with it.

### 4.3.2.6 CHESS securities

As one submission pointed out, the Act classifies financial products listed on the Australian Stock Exchange and held through the CHESS system as intermediated securities, rather than as investment instruments. They are intermediated securities because the operator of the CHESS system is an "intermediary" as defined in s 15(2)(b), and because the records that it maintains of holdings and transfers of financial products are defined to be "securities accounts" by s 15(7)(b). They are not investment instruments, because the definition of "investment instrument" excludes anything that is an intermediated security.

The classification of an ASX-listed security held through CHESS as an intermediated security rather than an investment instrument is counter-intuitive, because the manner in which securities are held in the CHESS system is very different to the type of custody arrangement that is at the heart of the concept of an intermediated security. The CHESS operator does not hold pools of securities as custodian for individual investors. Rather, the CHESS operator functions as a registrar for the entities that issue the securities, in that it maintains a sub-register of the entity’s shares or other securities as an agent of the issuing entity. This is almost the reverse of a custody arrangement, as the CHESS operator is acting for the issuer of the securities, not the person who has invested in them.

The Act would be simpler and more intuitive if shares or other securities listed on the Australian Stock Exchange and held through the CHESS system were treated as investment instruments, rather than as intermediated securities.

**Proposed recommendation 2.12:** That the Act be amended so that shares or other securities listed on the Australian Stock Exchange and held through the CHESS system are investment instruments, rather than intermediated securities.

### 4.3.2.7 Cash

It can be seen from Section 4.3.2.4 above that the definition of "financial product" is quite broad, at least as it applies to intermediated securities. Significantly, however, it excludes "cash".

This is consistent with the Hague Securities Convention and the UNIDROIT Securities Convention. The reason for this treatment of cash in those Conventions is not clear.

From a secured party's perspective, the exclusion of cash is inconvenient. If a secured party takes a security interest over a grantor's interest in shares held through a custodian, the secured party is likely to want its security interest to also attach to any dividends that the custodian receives (on the grantor’s behalf) in relation to the shares. The exclusion of cash has the effect however that the secured party cannot perfect by control over those amounts. Instead, it would need to perfect by registration, undermining the benefit of being able to perfect by control at all.
The difficulty is even more acute for the intermediary itself, if it is the secured party. Its security interest will typically be over the benefit of the various accounts that the grantor holds with it as intermediary. If the grantor directs the intermediary to sell some or all of the securities that it holds through the secured party (as intermediary), this will convert the asset that the grantor holds through the intermediary into cash, held by the intermediary on behalf of the grantor. The intermediary would want its security interest to grip that cash in the same way as it previously gripped the securities. As the security interest cannot be perfected over the cash by control, however, the intermediary would need to register a financing statement if it wanted to perfect that security interest.

Some intermediaries deal with this by holding cash for customers in a way that qualifies as an "investment instrument" (see the next Section), such as a cash management trust. This option may not always be available, however.

In my view, a secured party should be able to perfect by control over cash that is held via a custodian in the same way as it can perfect by control over other intermediated financial assets.

**Proposed recommendation 2.13:** If the concept of perfection by control over intermediated securities is retained, that the Act be amended to allow a secured party to perfect by control over cash that is held via a custodian in the same way as it can perfect by control over other financial assets.

### 4.3.3 Investment instruments

#### 4.3.3.1 Scope of the concept

A security interest may also be perfected by control if it is over an "investment instrument". That term is defined in s 10 by means of a lengthy and detailed list of specific financial instruments or assets. The meanings of the individual items in that list rely in turn on further definitions that are contained in the Corporations Act.

While this approach minimises duplication across the statute book, it does make the definition very unwieldy and unhelpful for users of the Act, as the definitions from the Corporations Act are themselves very complex. This can make it very difficult for a user of the Act to work out whether a particular financial asset is or is not an investment instrument. It is appropriate to ask whether the term could be defined in a simpler and more user-friendly way.

It should also be asked whether using defined terms from the Corporations Act is appropriate from a policy perspective, as the scope of those defined terms will have been set by reference to matters of corporations law policy. Those policies may well not be relevant for a secured transactions law. As one submission pointed out, for example, this has the result that the definition captures units in unit trusts that are managed investment schemes, but not otherwise. That might not be an appropriate outcome under the Act.

As a separate question, it should be asked why it ought to be possible to perfect by control over all the types of financial products that are currently within the definition of investment instrument in s 10. It is not readily apparent, for example, why it should be possible to perfect by control over derivatives (paragraph (c) of the definition), foreign exchange contracts (paragraph (d)) or certain options for the allotment of investment instruments (paragraph (d)).

I would welcome further comments on these questions.
Proposed recommendation 2.14: None at this stage, pending further consideration.

4.3.3.2 The options for perfecting by control over an investment instrument

A security interest over an investment instrument can be perfected by control in a number of ways, set out in s 27. Similar to the position in relation to intermediated securities, the mechanisms for perfecting by control over an investment instrument do not all clearly deliver on the publicity objective, although the majority of the options provided in s 27 are more likely to achieve this than the options for perfecting by control over intermediated securities under s 26. It should be considered, in the same way as discussed above for intermediated securities, whether the modes of perfecting by control over an investment instrument should be tightened so that only one secured party at a time can be perfected by control, or to ensure that a secured party will only have control if it is able to ensure that the investment instrument cannot be dealt with without its consent.

Again, I would welcome further comments on these questions.

Proposed recommendation 2.15: None at this stage, pending further consideration.

4.3.4 Intermediated securities and investment instruments – greater consistency?

The Act ensures that there is no overlap between the definitions of intermediated security and investment instrument, despite their close relationship. It does this by providing that personal property that might otherwise be an investment instrument will not be an investment instrument, if it is also within the definition of intermediated security.

While that removes the risk of definitional overlap, it does not greatly assist users of the Act, as they still need to work out which definition to apply. This can be important if they want to perfect by control, because the methods of perfecting by control in ss 26 and 27, though similar, are different in some subtle but significant ways.31

Some of the differences may reflect the different nature of the collateral involved, but others do not. It would simplify the operation of these provisions if they could be made more consistent.

Proposed recommendation 2.16: That the mechanisms for perfection by control in ss 26 and 27 be made more consistent.

4.3.5 ADI accounts

4.3.5.1 Is the definition too narrow?

The term "ADI account" is defined in s 10 in these terms:

**ADI account** means an account, within the ordinary meaning of that term, kept by a person (whether alone or jointly with one or more other persons) with an ADI that is payable on demand or at some time in the future (as agreed between the ADI and the person or persons).

31 A secured party faces the same challenge if it wants to perfect by registration, as it will need to decide which collateral class it should register against. There can even be some financial assets that fall through the cracks between the two definitions, and a security interest over such a financial asset can only be perfected by registration, against a different collateral class again. This will be considered in a later consultation paper.
Simply put, an ADI account is a bank account. However, a bank account is only an ADI account if it is held with an entity that is authorised to carry on banking business under the Banking Act 1959. It does not extend (for example) to foreign banks that are not so authorised, even if they are authorised to carry on banking business under the equivalent laws of another jurisdiction.

One submission queried why the term should be limited in this way. It may be that the definition has been limited to ADIs because it was thought that the term "ADI account" would be used in the Act in ways that had implications for the integrity of the Australian banking system. However, the submission made the point that a number of the provisions that refer expressly to ADI accounts are not there for the protection of the ADI or the banking system more generally, but rather for the benefit of parties dealing with the ADI. This is the case, for example, in s 33(1)(c) (which provides for the automatic perfection of a security interest in some types of proceeds) and s 340(5) and related provisions in Part 9.5 (which provide that some ADI accounts may be a "circulating asset"). Those sections will be considered elsewhere. If they remain in their current form, consideration should be given to expanding those provisions to apply to bank accounts more generally.

In the context of the perfection rules, however, it is clear that the definition is there to benefit ADIs. It does this in two ways. First, the Act makes it clear that only the ADI itself can perfect by control over an ADI account with it. Secondly, the Act provides that the ADI's perfection is automatic. If an ADI has a security interest over an ADI account with it, then it is automatically perfected by control by force of the Act, without the need for the ADI to register a financing statement.

4.3.5.2 Should a secured party other than the ADI itself be able to perfect by control?

Article 9 also provides that a bank's security interest over an account with it is automatically perfected. Unlike the Act, however, it allows other secured parties to perfect by control over a bank account as well, either by entering into a control agreement with the bank, or by becoming the holder of the account.

An early draft of the Act did allow for secured parties other than the ADI itself to perfect by control over an ADI account. That language however did not remain in the final form of the Act.

The two methods by which a secured party (other than the bank itself) may perfect a security interest by control under Article 9, namely by entering into a control agreement or by becoming the holder of the account, have parallels in pre-PPSA law. Before commencement of the Act, a person who took a mortgage over a bank account could ask the bank to acknowledge the existence of its mortgage, and to agree to act on instructions from the mortgagee if the account holder defaulted on its obligations to the mortgagee. It was also open to a mortgagee to require its customer to transfer funds in the account into a new account in the mortgagee's name.

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32 It also gives the ADI a superior priority position. See Section 6.4.1 below.
33 Section 25.
34 Section 75.
35 Article 9, § 9-104(a)(1).
36 Article 9, § 9-104(a)(2) and (3).
37 Personal Property Securities Bill 2008 (Cth), May 2008 Exposure Draft, cl 32.
It is of course still open to a secured party to ask an ADI to enter into a control agreement. That agreement could assist the secured party as a practical matter to control the flow of funds into and out of the account. A secured party can also still require its grantor to transfer funds in an account into a different account, in its name. Because these steps will not perfect the secured party’s security interest, however, the secured party would need to perfect by registration as well.

I had anticipated that submissions might propose that a secured party other than the ADI itself should be able to perfect over an ADI account by control, by entering into a control agreement with the ADI or by taking over the account. However, no submissions raised these issues. I will assume, unless I hear otherwise, that this means that this possibility does not need to be explored further.

4.3.5.3 **Should perfection by control be automatic?**

It should also be asked whether it is appropriate that the ADI’s security interest be perfected automatically, without the need to register a financing statement.

This is clearly a convenient position for ADIs, as they are perfected without needing to register against their customers. If it is accepted however that the primary purpose of perfection is to provide a mechanism for putting third parties on notice that a secured party may have security over a particular grantor’s collateral, then this automatic perfection is not so easy to justify, as it does not put outsiders on notice that the bank may have security over the account with it.

Two factors may mitigate against this concern. First, it is common knowledge that a bank’s standard account terms will typically contain a set-off clause that allows the bank to reduce all of its outstanding positions in relation to a customer down to one net balance. The same can also be achieved, at least to some extent, by the banker’s right at general law to combine accounts. Both set-off and combination of accounts are outside the Act.\[^{38}\] Secondly, many observers may already expect banks to routinely include a security interest in their standard account terms. Either way, the general expectation would be that banks are able to arrange their affairs in a way that ensures that they are not obliged to repay amounts owing to a customer on a bank account, until the customer has paid the bank all amounts owing to it. In other words, it could be argued that there is in fact no need for an ADI to separately publicise the existence of a security interest in an ADI account with it, such as by registration.

For these reasons, the current position under the Act, which allows an ADI to be automatically perfected by control over an ADI account with it, could be thought to be appropriate. I would be interested to hear if there are different views on this.

**Proposed recommendation 2.17:** None at this stage, pending further consideration.

4.3.6 **Negotiable instruments that are not evidenced by a certificate**

Section 21(2)(c)(iv) provides that a security interest may be perfected by control over a negotiable instrument that is not evidenced by a certificate. The mechanism for perfecting by control over such a negotiable instrument is then set out in s 29.

The term "negotiable instrument" is defined in s 10 to have a meaning that is significantly broader than the meaning of that term at general law. The breadth of that

\[^{38}\] Section 8(1)(d).
definition will be discussed later in this paper.\footnote{See Section 5.4.9.} For present purposes, it is sufficient to note that negotiable instruments are by their nature physical instruments, at least in the eyes of the general law, and that the notion of a negotiable instrument that is only in electronic form is not easy to conceptualise.\footnote{It is also not easy to reconcile with the definition of "negotiable instrument" itself. Again, see Section 5.4.9.}

Even if it is accepted that it is possible for a negotiable instrument to exist in electronic form, it should also be asked whether it is appropriate to allow a security interest over such a negotiable instrument to be perfected by control, when that option is not available for most other payment intangibles.

I would be interested to hear views on these points. Unless the provisions have a meaningful role to play in the Australian commercial environment, however, my preference would be to delete both ss 21(2)(c)(iv) and 29.

**Proposed recommendation 2.18:** That ss 21(2)(c)(iv) and 29 be deleted.

### Letters of credit

Section 21(2)(c)(v) provides that a security interest may be perfected by control over:

\[(v)\] a right evidenced by a letter of credit that states that the letter of credit must be presented on claiming payment or requiring the performance of an obligation;

The Act does not state positively what a secured party needs to do in order to perfect by control over such a right. Rather, the guidance that it provides is curiously expressed in the negative. Section 28 states:

\[28\] **Control of a letter of credit**

A secured party does not have control of a right evidenced by a letter of credit, to the extent of any right to payment or performance of an obligation by the issuer or a nominated person, unless the issuer or nominated person has consented to assigning the proceeds of the letter of credit to the secured party.

The application of the Act to letters of credit will be revisited in a later consultation paper. For present purposes, though, it should be asked whether it is appropriate to allow a security interest over rights evidenced by a letter of credit to be perfected by control in the manner contemplated by s 28.

Section 28 derives from a provision in Article 9.\footnote{Article 9, § 9-107.} The Official Comments\footnote{Official Comment 4 to § 9-107.} to that provision draw a distinction between the right to draw on a letter of credit, and the right to receive the payment that is due if a draw is made. Section 28 appears to be targeted at the latter, but this could be clearer. In any event, perfection in the manner described in s 28 does not appear to achieve the publicity objective of perfection, as it will not be readily apparent to an outsider that the payer under the letter of credit has consented to an assignment of the proceeds until the letter of credit is called, by which stage it may be too late.

So it is at least arguable that perfection by control over rights under a letter of credit, at least as currently formulated, does not sit well with the Act’s objective of providing transparency to outsiders. I would be interested to hear the views of others on this. I
would also be interested to hear whether this mode of perfecting over rights under a letter of credit is in fact being utilised by secured parties, as an alternative to registration.

The result of further feedback may be that it is appropriate to delete both ss 21(2)(c)(v) and 28.

**Proposed recommendation 2.19:** None at this stage, pending further consideration.

### 4.3.8 Satellites and other space objects

Section 28(2)(c)(vi) states that a security interest may be perfected by control over:

(vi) satellites and other space objects.

Unlike the other classes of collateral over which a security interest may be perfected by control, the Act provides no guidance on how to perfect by control over satellites or other space objects.

Section 28(2)(c)(iv) may have been included in the Act in response to work that has been done by UNIDROIT under the auspices of the Cape Town Convention, in relation to dealings in interests in space assets. That work has recently resulted in the 2012 Protocol to the Convention on International Interests in Mobile Equipment on Matters Specific to Space Assets. The inclusion of satellites and other space objects in s 20(2)(c) as a category of property over which a security interest may be perfected by control is however hard to reconcile with that Protocol, as the Protocol appears to rely principally on registration, rather than control, as the means by which a person can publicise their interest in a space asset.

My current view is that s 20(2)(c)(vi) should be deleted.

**Proposed recommendation 2.20:** That s 20(2)(c)(vi) be deleted.

### 4.3.9 Performance bonds and bank guarantees?

One submission queried whether it should also be possible to perfect by control over performance bonds and bank guarantees. This is presumably on the basis that s 21(2)(c)(v) currently allows a security interest over rights under a letter of credit to be perfected by control, and that performance bonds and bank guarantees perform a similar function to letters of credit.

Section 21(2)(c)(v) was discussed in Section 4.3.7 above. It will be seen from that Section that it must be questioned whether it is appropriate to allow a security interest over rights under a letter of credit to be perfected by control. For the same reasons, it must be asked whether it would be appropriate to extend the ability to perfect by control even further, to other instruments that perform a similar function. I would be interested to hear the views of others on this.

**Proposed recommendation 2.21:** None at this stage, pending further consideration.

### 4.4 Temporary perfection

### 4.4.1 Introduction

As has been mentioned previously, the purpose of requiring a secured party to perfect a security interest in collateral is to publicise the existence of the security interest, so that
third parties have an opportunity to learn of the existence of the security interest before they decide whether to take a potentially competing interest in the collateral.

The Act recognises however that there are some situations in which a secured party's security interest should be afforded the benefits (or at least some of the benefits) of perfection for a short period of time, to give the secured party a window of time within which it can take steps to perfect (or re-perfect) its security interest by registration, possession or control. Those situations are summarised in the table below.

<table>
<thead>
<tr>
<th>Section of the Act</th>
<th>Situation</th>
<th>Maximum period of temporary perfection</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. 22</td>
<td>Security interest is over goods in the possession of a bailee. The bailee has issued a negotiable document of title to the goods, but the secured party has not received it yet.</td>
<td>5 business days</td>
</tr>
<tr>
<td>2. 33(2)</td>
<td>Security interest attaches to proceeds but is not otherwise automatically perfected.</td>
<td>5 business days</td>
</tr>
<tr>
<td>3. 34(1)</td>
<td>Collateral is transferred.</td>
<td>24 months (or in some circumstances, 5 business days)</td>
</tr>
<tr>
<td>4. 35</td>
<td>Security interest is perfected by possession over goods held by a bailee, and goods are temporarily returned to the grantor or debtor for certain purposes.</td>
<td>5 business days</td>
</tr>
<tr>
<td>5. 36</td>
<td>Security interest is in a negotiable instrument or investment instrument is perfected by possession or control, and possession or control is given to the grantor or debtor for certain purposes.</td>
<td>5 business days</td>
</tr>
<tr>
<td>6. 38</td>
<td>A sale or lease of goods creates an account or chattel paper, which is transferred. If the goods are returned for certain reasons, the transferee is deemed to have a security interest over the returned goods.</td>
<td>5 business days</td>
</tr>
<tr>
<td>7. 39</td>
<td>Collateral subject to a perfected, registered or otherwise effective security interest overseas is relocated to Australia.</td>
<td>56 days (or in some circumstances, 5 business days)</td>
</tr>
<tr>
<td>8. 40</td>
<td>Security interest over intangible property or financial property was governed by foreign law (and was effective under that law), but the grantor becomes located in Australia.</td>
<td>56 days (or in some circumstances, 5 business days)</td>
</tr>
</tbody>
</table>

The Canadian PPSAs\(^{44}\) and the NZ PPSA\(^{45}\) contain provisions that are broadly similar to most of these provisions.

4.4.2 The grace periods

4.4.2.1 Five business days

The temporary perfection period in each of ss 22(2), 33(2), 35, 36 and 38, as well as in ss 34(1), 39 and 40 in some situations, is five business days. The corresponding period in the NZ PPSA is 10 working days,\(^ {46}\) and in the Canadian PPSAs is generally 15 days.\(^ {47}\)

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\(^{43}\) A security interest that is only temporarily perfected is more susceptible to being defeated by a claim of a buyer or lessee. See s 52 of the Act, discussed in Section 5.4.7 below.

\(^{44}\) Eg Sask PPSA, ss 5(3), 6(1), 7(3), 7.1(6) and (7), 24(4), 26, 28(3) and 29(4).

\(^{45}\) NZ PPSA, ss 27, 28, 31 and 47 to 49.

\(^{46}\) See note 45.

\(^{47}\) See note 44.
In my view, five business days is an unrealistic timeframe for the purposes of these provisions. It is understandable that the drafters of the Act would want to keep the period of temporary perfection to a minimum, because temporary perfection is not apparent to third parties and so does not satisfy the publicity function that is achieved through perfection by registration, possession or control. However, restricting the period of temporary perfection to five business days comes close to making temporary perfection a protective mechanism in name only, as it is too short a period for most secured parties to be able to take advantage of it. My current view is that we should adopt the New Zealand approach and allow a secured party 10 business days, not five business days, within which to perfect before losing the benefit of temporary perfection.

Proposed recommendation 2.22: That the references in ss 22(2), 33(2), 34(1), 35, 36, 38, 39 and 40 to "five business days" be replaced with "10 business days".

4.4.2.2 56 days

The principal period of temporary perfection in ss 39 and 40 is 56 days. The corresponding period under the NZ PPSA is 60 days. It is not clear why the drafters of the Act settled on a period of 56 days for these provisions. Whatever the reason, the choice of 56 days for the temporary perfection period appears rather odd to the reader, and is slightly less straightforward to work with. In my view, there is some (albeit modest) value in following the New Zealand approach, and making these periods in the Act 60 days as well.

Proposed recommendations 2.23: That the references in ss 39 and 40 to "56 days" be replaced with "60 days".

4.4.2.3 The effect of expiry of a period of temporary perfection

If a secured party perfects its security interest by registration, possession or control before expiry of a period of temporary perfection, then it will be able to preserve the benefit of having been temporarily perfected.

If a secured party does not perfect its security interest within the required time, the consequences vary. In the case of some of the temporary perfection provisions, the temporary perfection simply expires at the end of the period, and the security interest becomes unperfected at that time. For the other temporary perfection provisions, however, the security interest is taken to have not been perfected at all during the temporary perfection period. Using the same table as in Section 4.4.1, the division as between these two outcomes is as follows:

<table>
<thead>
<tr>
<th>Section of the Act</th>
<th>Situation</th>
<th>Maximum period of temporary perfection</th>
<th>Effect of expiry of period on the security interest</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. 22</td>
<td>Security interest is over goods in the possession of a bailee. The bailee has issued a negotiable document of title to the goods, but the secured party has not received it yet.</td>
<td>5 business days</td>
<td>Never perfected</td>
</tr>
<tr>
<td>2. 33(2)</td>
<td>Security interest attaches to proceeds but is not otherwise automatically perfected.</td>
<td>5 business days</td>
<td>Perfection just expires</td>
</tr>
<tr>
<td>3. 34(1)</td>
<td>Collateral is transferred.</td>
<td>24 months (or in some circumstances, 5 business days)</td>
<td>Perfection just expires</td>
</tr>
</tbody>
</table>

NZ PPSA, ss 27(1)(a) and 31(a).
The reasons for the differing approaches are not readily apparent. I would be interested to hear whether others are able to provide an explanation. If there is no good reason for the distinction being drawn, then my preference would be to apply the same rule in all cases, and to provide in all these provisions that the temporary perfection simply expires at the end of the period, if the secured party has not separately perfected its security interest by then.

Proposed recommendation 2.24: That ss 22, 39 and 40 be amended to provide that temporary perfection simply expires at the end of the period provided for in the section.

4.5 Other methods of perfection?

One submission suggested that a transfer of an account or chattel paper should be able to be perfected by giving notice of the transfer to the obligor, or by taking other steps that would require the obligor to make payments to the transferee (or someone on its behalf), rather than to the transferor. This was said to be directly analogous to perfection by possession or control of other types of collateral, and appropriate for that reason.

I can see that it might be convenient to secured parties to have another potential method of perfecting over accounts or chattel paper. In my view however, then this proposal would compromise the ability of the Act to achieve the objective of perfection, which is to provide third parties with a mechanism that allows them to determine without undue difficulty whether a grantor may have encumbered its property. If a secured party could perfect a transfer of an account by giving notice to the obligor, then a third party would only be able to detect the existence of the transfer by making enquiries of the obligor. That could be administratively cumbersome, and the obligor would in any event not be obliged to respond to a request for information. This would add to the workload for a searcher, and make the results of the search process less reliable.

In my view, the balance of convenience is against this proposal.
4.6 Continuity of perfection

4.6.1 Section 56

Section 56 explains how a security interest can be perfected in different ways at different times, yet remain perfected. It provides:

(1) For the purposes of this Act, a security interest is continuously perfected after a particular time if the security interest is, after that time, perfected under this Act at all times.

(2) A security interest may be continuously perfected after a particular time even if, after that time, it is perfected in 2 or more different ways:

(a) at any particular time; or

(b) at different times.

A number of submissions pointed out that the wording of s 56 is not easy to follow, and suggested that it be replaced with the following simpler formulation from s 23(1) of the Sask PPSA:

23(1) If a security interest is originally perfected pursuant to this Act and is again perfected in some other way pursuant to this Act without an intermediate period when it is unperfected, the security interest is continuously perfected for the purposes of this Act.

This would be a worthwhile simplification of the Act.

Proposed recommendation 2.25: That s 56 be amended to reflect the language of s 23(1) of the Sask PPSA.

4.6.2 Re-perfection

One submission noted that the Act does not make express provision for a situation where a registration has been discharged or allowed to lapse in error. The submission drew attention to Sask PPSA s 35(7), which affords a secured party in these circumstances a 30-day window to re-perfect without losing the benefit of continuous perfection (except as against other security interests, for advances made or contracted for during the intervening period).

The other Canadian PPSAs have similar provisions. The NZ PPSA does not.

I am not inclined to recommend that a version of Sask PPSA s 35(7) be included in the Act. While it would provide some relief for secured parties that discharge a registration in error or fail to renew a registration on time, it would complicate the priority rules in a way that I do not feel would justify the outcome. It could, for example, give rise to circular priority disputes between multiple secured parties for which there is no solution. See Section 6.6 below.

Another option would be to give courts the power to provide relief for registration errors, at least where they do not adversely affect third parties. This will be considered in a later paper. I would however be interested to hear if there is additional support for including a provision along the lines of s 35(7) of the Sask PPSA.

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See Cuming Walsh & Wood, pages 298 to 299.
5. DEALINGS IN COLLATERAL

5.1 Terminology

The Act uses a number of different terms to refer to what might loosely be described as a dealing with property. For example, s 12(2) refers to an “assignment” and a “transfer” as distinct concepts. Section 31(1)(a) talks of a “dealing” in collateral, and s 32(1)(a) refers separately to both a “dealing” and a “disposal”. A large number of provisions refer to a “transfer” of collateral.

It is not clear to what extent these terms are intended to embody different meanings, or are just being used as alternative expressions for the same concept. This uncertainty makes it difficult for secured parties to be confident that they understand the implications for their security interest, if the grantor deals with the collateral in different ways.

Proposed recommendation 2.26: That careful consideration be given to the ways in which the Act refers to dealings in collateral, that consistent terminology be used where appropriate, and that it be made clear, if different terms are used in different contexts, what the differences in meaning are as between those different terms.

5.2 The effect of a lease on a security interest over the leased goods

5.2.1 Policy issues

Perhaps the most challenging question raised in the submissions related to the effect of a lease of goods on a security interest that had previously been granted over the goods by the lessor. A number of submissions raised this issue, including in the context of lease/sublease chains, where it was said to be unclear what effect a sublease could have on the interest of a lessor further up the lease chain. Submissions noted that it is unclear whether the interest of such a lessor would be compromised if the sublessee sold or granted security over the goods, or if the sublessee became insolvent in a way that engaged the “vesting on insolvency” rule in s 267.

There is no doubt that the Act does not provide clear guidance on this question. The question is also an important one, and I agree that the position should be clarified. Before it can be clarified, though, it first needs to be determined what principles the Act should be implementing, and it is at this point that the submissions diverge into two schools of thought. To explain the divergence, I would like to start with three simple fact patterns. In each case, an owner of goods grants security over the goods, and then deals with the goods in a way that does not cause the security interest in the goods to be extinguished under s 32. The dealing is in the ordinary course of the owner’s business of selling or leasing goods of the relevant kind, so the dealee “takes free” under s 46.

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50 See also Consultation Paper No. 1, Section 4.2.1.3.
51 See Section 5.3 of this paper.
Fact pattern 1 – outright sale

In this fact pattern, Owner has granted security over its goods to Owner SP. Despite this, Owner sells the goods to Purchaser, in a manner that allows Purchaser to take the goods free of Owner SP's security interest. This means for practical purposes that Owner SP's security interest over the goods is extinguished. Owner SP's security interest attaches to the sale price instead, as proceeds of the goods.

Purchaser also gives security over the goods to its bank, Purchaser SP. Purchaser clearly has rights in the goods, and so is able to grant that security.

The security interests of Owner SP and Purchaser SP cannot come into conflict, as they are over different items of collateral.\(^\text{52}\)

Fact pattern 2 – short-term lease

In this fact pattern, Lessor has again granted security over its goods to Lessor SP. This time, however, Lessor leases the goods to Lessee under a short term rental arrangement that is neither an in-substance security interest, nor a PPS lease. Lessee takes the goods free of Lessor SP's security interest, but that does not mean that Lessor SP ceases to have security over the goods. Rather, it means that Lessee can hold and use the goods under the lease agreement free from interference by Lessor SP. Subject to that restriction, Lessor SP continues to have security over the goods, with Lessor as the grantor.

Lessee has also given security to its bank, Lessee SP. That is unlikely (in this context) to be a specific security interest over the goods, and more probably will be under a general security interest. It is not clear whether the Lessee has sufficient rights in the collateral to grant security over the goods themselves, or whether the Lessee can only give security over its possessory rights to the goods under the lease agreement. This question is considered in Section 2.2 above.

\(^{52}\) That situation could change if the sale were to be rescinded, as Owner SP's security interest could then re-attach to the goods under s 37. The ensuing priority competition between Owner SP and Purchaser SP would be regulated by s 76. See Section 6.12 below.
Fact pattern 3 – finance lease

This fact pattern is the same as fact pattern 2, except that this time the lease is an insubstance security interest under s 12(1).

The key difference between the two schools of thought regarding the effect of a lease on a pre-existing security interest appears to be in the effect that the finance lease in this fact pattern should have on Lessor SP’s security interest. Should the finance lease be treated the same as the short-term lease in fact pattern 2, so that Lessor SP’s security interest remains attached to the goods (with Lessor as the grantor)? Or should the analysis recognise that the finance lease is the commercial equivalent of a sale, and treat the finance lease as having the same effect on Lessor SP’s security interest as the sale in fact pattern 1?

If the finance lease is treated like the short-term lease in fact pattern 2, then Lessor SP will still have security over the goods. However, Lessee SP will have no way of discovering the existence of that security interest, as that security interest is perfected by registration against Lessor, not Lessee. The same problem would arise if Lessee had sold the goods rather than granted security over them, as a buyer, on searching the register against Lessee, would discover the security interest held by Lessor (if Lessor had perfected by registration), but would not discover the security interest held by Lessor SP.

It would be even harder for a buyer to discover the existence of Lessor SP’s security interest if Lessor had failed to register. If Lessor had failed to register, the buyer could take free of Lessor’s (unperfected) security interest. However, this would not affect Lessor SP’s security interest, as it would remain attached to the goods, and continue to be perfected (by its registration against Lessor). Lessor SP’s registration would essentially be undiscoverable. This could greatly compromise the transparency of the Register.

If the finance lease is treated as if it were a sale, however, very different consequences will follow. In this case, Lessor SP’s security interest will no longer be attached to the goods. Instead, its security interest will attach to Lessor’s rights under the lease agreement, as proceeds of the goods. Those rights would include Lessor’s reversionary interest in the goods. Lessee SP, in contrast, does get security over the goods and not just over Lessee’s contractual rights under the lease agreement.

Similarly, if Lessee had sold the goods rather than grant security over them, the buyer would be able to take the goods free of Lessor SP’s security interest – not because of a taking free rule, but rather because Lessor SP’s security interest was no longer attached to them.

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That would admittedly be of questionable value in a finance lease, as the lessor under a finance lease does not typically want or expect to get the goods back on expiry of the lease.
In summary then, if a finance lease (or any other lease that is a security interest) is treated as if it were a sale, then the outcome favours third parties dealing with the lessee ahead of a secured party to the lessor, and enhances the value of the Register. Conversely, if a finance lease is treated as just a lease and not as the commercial equivalent of a sale, then the outcome favours the lessor's secured party over third parties dealing with the lessee,54 and limits the value of the Register.

As a matter of principle, I believe it makes more sense within the construct of the Act to treat a finance lease (or any other lease that is a security interest) as the equivalent of a sale for these purposes. It is true that this disadvantages a secured party to the lessor, but the secured party is no more disadvantaged than it would have been if the lessee had sold the goods, rather than leased them as a commercially-equivalent transaction to a sale. And as between the two groups of aggrieved innocent parties - the lessor and its secured party on the one hand, and the lessee’s secured party or buyer on the other - the first group is in a better position to manage the risk of lessee default than the second. This approach, of treating a finance lease for these purposes as the equivalent of a sale of the leased goods, would also be consistent with what I understand to be the position under Article 9 and the Canadian PPSAs.

I appreciate however that this is a particularly thorny issue, and would welcome further discussion before I formulate a recommendation.

**Proposed recommendation 2.27:** None at this stage, pending further consideration.

5.2.2 **Fact pattern 3 - effect of s 267**

The transaction between Lessor and Lessee in fact pattern 3 is itself a security interest. That raises one additional risk that was not present in fact patterns 1 and 2, which is the risk that Lessee may become insolvent. If Lessor fails to perfect its security interest under the finance lease and Lessee becomes insolvent, Lessor's interest in the goods (effectively, its title) may vest in the Lessee under s 267.

A number of submissions questioned what effect this should have on the security interest held by Lessor SP. Should Lessor SP's security interest be derivative of Lessor's security interest under the finance lease (in which case the security interest would effectively be extinguished, if Lessor's security interest vests in the Lessee under s 267)? Or should Lessor SP's security interest be able to survive, despite a vesting of Lessor's security interest?

If Lessee in fact pattern 3 has taken free of Lessor SP's security interest, then it follows that Lessor SP's security interest "detaches" from the goods for the duration of the lease,55 and attaches instead to Lessor's rights under the lease, as proceeds of the goods. This means that Lessor SP can be no better a position than Lessor, as Lessor SP only has security over the rights held by Lessor. If those rights vest in Lessee on insolvency under s 267, then nothing is left for Lessor SP's security interest to be attached to. This view also appears to have the support of the majority (but not all) of the submissions that commented on this. I would however be interested to hear of any alternative lines of analysis that still allow the Act to function as a logical whole.

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54 Subject to the discussion in Section 2.2.

55 Because the finance lease is treated for the purposes of the Act as the functional equivalent of a sale.
5.2.3 **Lease/sublease chains**

One submission focused in particular on the effects of a sublease on the position of an owner of goods higher up a lease chain. The issue can be shown by the following fact pattern:

![Diagram of lease/sublease chains]

This fact pattern is functionally the same as fact pattern 3. That is because the head lease in this fact pattern is itself characterised by the Act as a security interest that is granted by Lessor to Head Lessor. If you substitute "Owner SP" for "Head Lessor" in the diagram (and reverse the top arrow to reflect the direction in which that security interest is taken to be granted), the fact patterns can be seen to be the same.

One submission made the point quite forcefully that the equipment leasing industry is particularly affected by the way in which the Act enables a sublease of goods to adversely impact the interest of an owner or other lessor further up the lease chain. It noted that equipment lessors have little ability to control what happens to leased equipment in the hands of their lessee customers. A customer might sublease equipment to a third party under a transaction that is itself a security interest, even if the head lease prohibits this. That sublease might be a formal, documented agreement, or an arrangement of a more informal nature. A customer that is part of a corporate group might also make the equipment available to other members of the group, again on either a formal or an informal basis.

That submission suggested a number of ways in which these risks for a head lessor (and to some extent for its customer as well) could be ameliorated.

As a threshold matter, I should note that I am not in favour of amending the Act to provide ad hoc solutions to individual problems, unless there is a truly pressing need to do so. Also, any solutions should not be limited in their application to security interests that happen to be in the form of a lease, as that would re-introduce some of the artificial form-based distinctions that the Act largely eradicates. The issues described above are ones that can affect any secured party to a lessor, not just one who happens to be the owner of the leased goods, so I will approach them as ones that should be considered for secured parties generally, not just for lessors.

**Vesting on insolvency – s 267**

The submission suggested that s 267 should not apply to a security interest over equipment if, at the time of insolvency, there is any registration on the Register that

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56 See Annexure B.
identifies the specific equipment. That identification could be by way of serial number, and the submission suggested that the categories of collateral that can be identified by way of serial number could be widened, to extend the reach of this protective measure. The submission suggested that it might also be possible to introduce a new collateral class, called “Other goods identified”, and that the protective measure could extend to collateral in that class as well.

Section 267, the collateral classes and the concept of serial-numbered property will all be considered in later consultation papers. At this point, I would simply note that these suggestions have been raised, and that I will respond to them in those later papers.

Goods leased to a corporate group

The same submission noted that it is common for an equipment lessor to lease goods to a particular company in a corporate group, on the basis that the company would then make the equipment available to other members of the group from time to time under arrangements that could be a PPS lease. The submission suggested that it should be sufficient, in order to perfect a security interest granted by a member of a corporate group under such an "internal" PPS lease, that a financing statement just be registered against the asset-holding member of the group. The submission went on to acknowledge that this solution might need to be limited to serial-numbered property (or goods that are "Other goods identified", as noted above).

It is not clear whether this proposal was put just in the context of s 267, or more generally. To the extent it relates to s 267, I will return to the proposal in a later paper. To the extent it is intended to apply more generally, though, I am not in favour of it. At the moment, a person who searches the Register for security interests granted by a corporate grantor need only search against the grantor’s details. This proposal would change that, as it would allow a security interest to be perfected by a registration that identified only the serial number (or other identifier) of the goods. While that could alleviate the burden for some secured parties, it would be a radical change to the overall architecture of the Act, and the benefits that it would bring to those secured parties would be outweighed, I expect, by the detriments that it would produce for others.

I should note in any event that many if not most of those informal intra-group leasing arrangements would only be PPS leases because they have an indefinite term. I have indicated in Consultation Paper No. 1 that I think the definition of PPS lease in s 13 should be amended so that it does not capture a lease of an indefinite term unless it runs for more than one year. That may go some way to alleviating this concern.

5.3 Section 32

5.3.1 Introduction

Section 32 contains rules for what happens when collateral gives rise to proceeds. The core provision is s 32(1). It states:

(1) Subject to this Act, if collateral gives rise to proceeds (by being dealt with or otherwise), the security interest:

(a) continues in the collateral, unless:

(i) the secured party expressly or impliedly authorised a disposal giving rise to the proceeds; or
(ii) the secured party expressly or impliedly agreed that a dealing giving rise to the proceeds would extinguish the security interest; and

(b) attaches to the proceeds, unless the security agreement provides otherwise.

A similar provision can be found in the Canadian PPSAs and the NZ PPSA. The language of s 32(1) has raised a number of very practical problems.

5.3.2 The meaning of "continues in the collateral"

Section 32(1)(a) says that the security interest "continues in" the collateral. A similar expression is used in Part 3.4, in relation to security interests over goods that become an accession, or are processed or commingled.

It is not clear how the term "continues in" is to be lined up against the continuum used elsewhere in the Act, of a security interest being "attached to collateral", "enforceable against a third party" and "perfected". My view is that "continues in" has the same meaning as "remains attached to", although this is not entirely clear.

If I am correct that "continues in" should have the same meaning as "remains attached to", then I query whether it would make the Act easier to understand if it just said so. I am mindful of the fact that the Canadian PPSAs and the NZ PPSA use the expression "continues in", but do not think that this should be grounds to not make what could otherwise be a helpful clarification. I would however be interested to hear the views of others on this.

5.3.3 What happens if there are no proceeds?

Section 32 is only engaged if a dealing produces proceeds. It does not say what happens if there are none – for example, if a grantor makes a gift of collateral, or if a grantor disposes of collateral in satisfaction of a pre-existing debt. A security interest should be able to remain attached to the collateral even if it is dealt with in a way that does not give rise to proceeds, despite the fact that s 32 is silent on the point. It would however be helpful to confirm this.

5.3.4 What happens if the secured party consents to a disposal of collateral, but only on the basis that its security interest remains attached?

Section 32(1)(a)(i) appears to suggest that a security interest will not continue in collateral that is disposed of, if the secured party expressly or impliedly authorised the disposal. If correct, this would mean that it is not open to a secured party to consent to a disposal on the basis that its security interest remains attached to the collateral after the disposal.

It has been suggested in relation to the Canadian PPSAs that the equivalent provision in that legislation should be read with an implied qualification to this effect, ie that the security interest is only extinguished if the secured party agreed that the disposal would extinguish its security interest. It is possible to find some support for this in the language of the Act, but equally possible to point to factors in the Act that argue for the

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57 Eg Sask PPSA, s 28(1).
58 NZ PPSA, s 45(1).
59 Cuming Walsh & Wood, pages 383 to 385.
opposite view. It is also instructive to note that the corresponding provision in Article 9 was amended some years ago to make this explicit.\textsuperscript{60} Either way, this uncertainty is undesirable.

5.3.5 \textbf{A possible alternative}

The uncertainties described above could be overcome, in my view, if s 32(1) were recast along these lines:

(1) Subject to this Act:

(a) if collateral is [dealt with],\textsuperscript{61} the security interest remains attached to the collateral, unless the secured party expressly or impliedly agreed that the [dealing] would extinguish the security interest; and

(b) if collateral gives rise to proceeds (by being [dealt with] or otherwise), the security interest attaches to the proceeds unless the security agreement provides otherwise.

I would be interested to hear the views of others on this.

\textbf{Proposed recommendation 2.28:} That s 32(1) be amended along the lines described above.

5.3.6 \textbf{Enforcing against both the collateral and the proceeds}

5.3.6.1 \textbf{Introduction}

Section 32(1) provides a secured party with a potential windfall. Its security interest will remain attached to the original collateral (in the hands of the dealee), and will also attach also to the proceeds from the dealing that were received by its grantor. While the secured party can of course only recover its secured amount once, if it had been under-secured (ie if the secured amount had been more than the value of the collateral), then the secured party could benefit from the dealing, because it can now pursue both the collateral and the proceeds.

Section 32(2) counters this potential windfall, by providing as follows:

(2) If the secured party enforces a security interest against both collateral (other than an investment instrument or an intermediated security) and proceeds, the amount secured by the security interest in the collateral and proceeds is limited to the market value of the collateral immediately before the collateral gave rise to the proceeds.

Section 32(3) then qualifies this, by providing that s 32(2) does not apply if the transferee of the collateral had actual or constructive knowledge that the transfer was in breach of the security agreement.

The Canadian PPSAs\textsuperscript{62} and the NZ PPSA\textsuperscript{63} contain a similar provision. Despite this, the provision raises a number of issues.

\textsuperscript{60} Article 9, § 9-315(a)(1).
\textsuperscript{61} See Section 5.1.1.
\textsuperscript{62} Eg Sask PPSA, s 28(1).
\textsuperscript{63} NZ PPSA, s 45(2).
5.3.6.2 Is the limitation appropriate?

While s 32(2) is intended to prevent a secured party from getting a windfall benefit by pursuing both the collateral and the proceeds, the section could in fact harm the secured party, because it caps the amount it can recover at the market value of the collateral immediately before the collateral gave rise to the proceeds. This could penalise the secured party if the market value of the collateral could increase after that time. Section 32(2) does not apply to two such types of collateral (investment instruments and intermediated securities), but there are other types of collateral (such as commodities, or works of art) that could increase in value over time as well.

The second issue with the provision is that it potentially makes an incorrect assumption about the nature of proceeds. The provision makes sense (subject to the previous paragraph) if the proceeds in question are a replacement of the original collateral – for example, if the grantor sold the collateral for cash, or exchanged it for another asset. Under the definition of “proceeds” in s 31, however, proceeds can include any personal property that derives from a dealing with the collateral. This could include revenue that flows from a dealing with the collateral, and not just be property that is received as a replacement of the property’s capital value.

The provision accommodates this to some extent, by excluding investment instruments and intermediated securities. The issue could still arise however – for example, if the grantor hires out goods for rent (under s 31(1)(a)), or grants a licence of intellectual property in return for royalties (under s 31(1)(d)). In these circumstances, it is arguable that the limitation in s 32(2) is not appropriate.

If s 32(2) is to produce a balanced outcome, it needs to respond to these concerns. It could be argued however that the provision is not even needed (or appropriate). For example, it might be said that the capacity for the section to produce a windfall benefit for the secured party is more perceived than real, as it is only an issue if the secured party was under-secured. One might also query why it is appropriate to shelter the grantor from the consequences of its breach of its security agreement, and why it is appropriate to protect the dealee just because the secured party chooses to pursue the proceeds in the hands of the grantor as well – if the secured party chose to enforce only against the collateral in the hands of the dealee, then the limitation in s 32(2) would not be engaged. These arguments could suggest that s 32(2) should be deleted. I would be interested to hear the views of others on this.

And finally on s 32(2), the language of s 32(3) suggests that a dealing covered by s 32(2) needs to be a “transfer”. This may not always be the case, however, unless "transfer" is given a very broad meaning. If ss 32(2) and (3) are retained, then this should be clarified.

Proposed recommendation 2.29: None at this stage, pending further consideration.

5.3.7 Section 32(5) – priority in relation to proceeds

Section 32(5) provides as follows:

(5) For the purposes of section 55 (default priority rules), the time of registration or possession in relation to original collateral, or the time of perfection of a security interest in original collateral, is also the time of registration, possession or perfection in relation to the proceeds of the original collateral.

See Section 5.1.
There are two aspects of this section that are worth considering. First, it is not clear why the provision refers in two places to "possession". It may be that these references could be deleted. Secondly, the provision may be able to be simplified by using the concept of a security interest's "priority time" (as defined in s 55(5)), in that it could simply provide that the priority time for the proceeds is the same as the priority time for the original collateral. I would be interested to hear whether others agree.

It is also not clear that it is desirable to limit the application of this rule to the default priority rules in s 55. While it is perhaps appropriate that the rule not apply to other priority rules, it should perhaps be able to apply in some other contexts, such as the vesting rule in s 588FL of the Corporations Act. There may also be other circumstances to which the rule should apply as well. I would be interested to hear the views of others on this.

**Proposed recommendation 2.30**: None at this stage, pending further consideration.

5.4 **The taking free rules**

5.4.1 **Terminology**

5.4.1.1 **Introduction**

The Act prescribes a range of circumstances in which a person who acquires an interest in collateral can take the interest free of an existing security interest over the collateral. Most of these rules are located in Part 2.5 of the Act.

Sections 5.4.1.2 to 5.4.1.4 discuss some general questions relating to the formulation of the taking free rules. Sections 5.4.2 to 5.4.10 discuss some of the detail of individual rules. Sections 5.4.1.12 to 5.4.14 then consider other relevant issues.

5.4.1.2 **The "value" requirement**

5.4.1.2.1 **The meaning of "value" and "new value"**

The term "value" is defined in s 10 in this way:

value:

(a) means consideration that is sufficient to support a contract; and
(b) includes an antecedent debt or liability; and
(c) in relation to the definition of purchase money security interest—has a meaning affected by section 14.

The term "new value" is also defined in s 10:

new value means value other than value provided to reduce or discharge an earlier debt or liability owed to the person providing the value.

I will return to the content of these definitions in Section 5.4.1.2.3.

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55 For an explanation, see Cuming Walsh & Wood, pages 583 to 584.
56 Section 588FL of the Corporations Act will be considered in a later paper.
5.4.1.2.2 How they are used

Most of the taking free rules provide that a person will only take an interest in collateral free of a security interest if, among other things, the person has provided either "value" or "new value" for the interest. The position for each of the taking free rules is summarised in the table below. (It will be seen that the table includes a number of rules that are currently classified by the Act as priority rules, rather than taking free rules. As this paper discusses further below, I am of the view that it makes more sense for them to be treated as taking free rules, and moved to Part 2.5.)

<table>
<thead>
<tr>
<th>Section</th>
<th>Circumstance</th>
<th>Value required</th>
</tr>
</thead>
<tbody>
<tr>
<td>43</td>
<td>Unperfected security interest</td>
<td>Value</td>
</tr>
<tr>
<td>44</td>
<td>Serial-numbered property</td>
<td>None</td>
</tr>
<tr>
<td>45(1)</td>
<td>Motor vehicle – the &quot;day and a half&quot; rule</td>
<td>New value</td>
</tr>
<tr>
<td>45(3)</td>
<td>Motor vehicle – seller or lessor is a prescribed person</td>
<td>New value</td>
</tr>
<tr>
<td>46</td>
<td>Ordinary course of business</td>
<td>None</td>
</tr>
<tr>
<td>47</td>
<td>Low-value personal domestic or household property</td>
<td>New value</td>
</tr>
<tr>
<td>48</td>
<td>Currency</td>
<td>None</td>
</tr>
<tr>
<td>49</td>
<td>Purchaser of investment instrument or intermediated security on stock exchange or similar</td>
<td>None</td>
</tr>
<tr>
<td>50</td>
<td>Investment instrument with possession or control</td>
<td>Value</td>
</tr>
<tr>
<td>51</td>
<td>Intermediated security in consensual transaction</td>
<td>Value</td>
</tr>
<tr>
<td>52</td>
<td>Temporarily perfected security interest</td>
<td>New Value</td>
</tr>
<tr>
<td>69</td>
<td>Creditor receiving payment of a debt</td>
<td>None</td>
</tr>
<tr>
<td>70</td>
<td>Negotiable instrument with possession or control</td>
<td>Value</td>
</tr>
<tr>
<td>71</td>
<td>Chattel paper in consensual transaction</td>
<td>New value</td>
</tr>
<tr>
<td>72</td>
<td>Negotiable document of title</td>
<td>Value</td>
</tr>
</tbody>
</table>

5.4.1.2.3 Rationale for the variations in usage

The use of "value" or "new value" in the taking free rules is broadly consistent with the approach taken in the Canadian PPSAs and the NZ PPSA. Despite this, it is not easy to extract a consistent rationale for the choices that have been made in the various taking free rules.

"Value" vs "new value"

The choice of "new value" for some of the taking free rules, over "value", may have been driven by a desire to ensure that the rule is only engaged if the relevant transaction produces some proceeds that the secured party's security interest can then attach to under s 32. It is not clear however why that approach was not used for the other taking free rules as well. And in any event, the new value provided by the person who requires the interest needs only to be sufficient consideration to support a contract. It does not need to reflect the market value of the interest being acquired, and may only be a nominal amount.

No value at all?

The fungible nature of currency may make it appropriate for there to be no value requirement in s 48 (although I have another concern with that taking free rule, that I
will return to), and the nature of the processes by which investment instruments or intermediated securities are traded on a stock exchange makes it impracticable to impose a value requirement on the taking free rule in s 49. And it is probably not necessary to specify a value requirement in s 69 as currently formulated, as the payment being received will discharge the relevant debt. It is less easy to understand, however, why there is no clear value requirement in s 44 or 46.

I would be interested to hear whether a more cogent explanation can be provided for the choices of "value", "new value" or "no value" in the rules listed in the table. I would also like to hear whether it might be appropriate to use a consistent requirement (for example, a requirement that there be new value) for all the rules to apply (except for the rules in ss 48, 49 and 69), and whether it is acceptable as a policy matter that the new value itself could potentially only be a nominal amount.

**Proposed recommendation 2.31:** None at this stage, pending further consideration.

### 5.4.1.3 The "knowledge" qualifier

Most of the taking free rules provide that they will not apply if the person acquiring the interest has a specified level of knowledge of the security interest, or was involved in its creation. The disentitling factors can be any of:

- being a party to the transaction that gave rise to the security interest;
- having actual or constructive knowledge of the security interest;
- having actual knowledge that the transaction breaches the security agreement that provides for the security interest; or
- having actual or constructive knowledge that the transaction breaches the security agreement that provides for the security interest.

Using the same table as in the previous Section, the requirements for the different taking free rules are as shown below.

<table>
<thead>
<tr>
<th>Section</th>
<th>Circumstance</th>
<th>Value required</th>
<th>Knowledge qualifier</th>
</tr>
</thead>
<tbody>
<tr>
<td>43</td>
<td>Unperfected security interest</td>
<td>Value</td>
<td>Party to transaction</td>
</tr>
<tr>
<td>44</td>
<td>Serial-numbered property</td>
<td>None</td>
<td>Party to transaction</td>
</tr>
<tr>
<td>45(1)</td>
<td>Motor vehicle – the &quot;day and a half&quot; rule</td>
<td>New value</td>
<td>Actual or constructive knowledge of security interest</td>
</tr>
<tr>
<td>45(3)</td>
<td>Motor vehicle – seller or lessor is a prescribed person</td>
<td>New value</td>
<td>Actual or constructive knowledge of breach</td>
</tr>
<tr>
<td>46</td>
<td>Ordinary course of business</td>
<td>None</td>
<td>Actual knowledge of breach</td>
</tr>
<tr>
<td>47</td>
<td>Low-value personal domestic or household property</td>
<td>New value</td>
<td>Actual or constructive knowledge of breach</td>
</tr>
<tr>
<td>48</td>
<td>Currency</td>
<td>None</td>
<td>Actual or constructive knowledge of security interest</td>
</tr>
<tr>
<td>49</td>
<td>Purchaser of investment instrument or intermediated security on stock exchange or similar</td>
<td>None</td>
<td>None</td>
</tr>
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<td>50</td>
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<td>Section</td>
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</tr>
<tr>
<td>72</td>
<td>Negotiable document of title</td>
<td>Value</td>
<td>Actual or constructive knowledge of breach, if in business of acquiring such documents; otherwise, actual or constructive knowledge of security interest</td>
</tr>
</tbody>
</table>

These qualifiers broadly mirror the position under the Canadian PPSAs and the NZ PPSA. Again, however, there is no obvious explanation for the distinctions, except in relation to the taking free rule in s 49 (where the realities of the trading of securities on a stock exchange make a knowledge qualifier impracticable).\(^67\)

**Section 48**

In my view, the current knowledge qualifier in s 48 is too tough. It might be argued that the fungible nature of currency is such that any type of knowledge qualifier is inappropriate. At a minimum, though, I believe that the holder of the currency should not be deprived of the benefit of the taking free rule just because they had actual or constructive knowledge of the existence of the security interest. The qualifier should only disentitle the holder from relying on the rule if they had actual (or possibly actual or constructive) knowledge that their taking of the currency was a breach of the security agreement that gave rise to the security interest. I also am of the view that s 48 needs to be considered in tandem with s 69. This is discussed further in Section 5.4.8.

**Generally**

The qualifier in each of the taking free rules clearly needs to be appropriate for that rule. Despite this, I suspect that some rationalisation of the use of the qualifiers in the taking free rules is both possible and appropriate. I would be interested to hear views on how this could be done.

**Proposed recommendation 2.32:** None at this stage, pending further consideration.

### 5.4.1.4 Meaning of "buyer" and "lessee"

Most of the taking free rules operate in favour of a buyer or lessee of collateral. The terms "buyer" and "lessee" are not defined.

The term "lessee" is well-understood, and requires no further comment. The use of the term "buyer" in some of the taking free rules has however raised the question of the extent to which this imports requirements from sale of goods legislation (or the general law, in the case of collateral that does not consist of goods), so that a taking free rule will only operate in favour of a person as a "buyer" if the transaction in question is one that is otherwise a contract of sale and purchase on general principles.

\(^67\) Indeed, knowledge is irrelevant, as the buyer will not know who the seller is.
This question has been explored at some length in a recent academic paper. The view of the paper's author, with which I agree, is that the meaning of the term "buyer" as used in the Act should not be extracted solely from the language of the Act itself, but should be determined by reference to the broader Australian legal framework of which the Act forms part.

I would however add one overlay to this, which is that there is one respect in which the framework of the Act dictates an outcome that goes beyond the general principles applicable to buyers and sellers. Because the Act treats a grantor of a security interest as if it were the owner of the collateral even if it is not the owner on general legal principles, the implication for the taking free rules is that a grantor can be a seller of collateral even if it does not have title (for example, if the grantor is the purchaser of goods subject to retention of title, or a lessee of goods under a PPS lease). To this extent, the principles that underpin the Act need to prevail over the principles that would otherwise apply at general law.

**Proposed recommendation 2.33:** None at this stage, pending further consideration.

5.4.2 Serial-numbered property

5.4.2.1 Section 44

5.4.2.1.1 The provision

Section 44 provides a taking free rule for serial-numbered property, as follows:

(1) A buyer or lessee of personal property takes the personal property free of a security interest in the property if:

(a) the regulations provide that personal property of that kind may, or must, be described by serial number in a registration; and

(b) searching the register, immediately before the time of the sale or lease, by reference only to the serial number of the property, would not disclose a registration that perfected the security interest.

Exceptions

(2) Subsection (1) does not apply if:

(a) the buyer or lessee holds the personal property:

(i) as inventory; or

(ii) on behalf of a person who would hold the collateral as inventory; or

(b) the security interest was created or provided for by a transaction to which the buyer or lessee is a party, unless the personal property concerned is of a kind prescribed by regulations for the purposes of this paragraph.

The Regulations provide that the personal property that "may, or must, be described by serial number in a registration" is:

- motor vehicles;

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69 Section 44(3) contains a transitional provision that is not relevant for current purposes.

70 Item 2.2 in Schedule 1 to the Regulations.
• aircraft;
• watercraft; and
• certain types of intellectual property (designs, patents, plant breeder's rights, trademarks or licences over any of them).

5.4.2.1.2 Non-application to inventory

The taking free rule in s 44 is not available for a buyer or lessee that holds the acquired interest as inventory. This broadly reflects the approach of the corresponding provision in the NZ PPSA,71 but not the corresponding provision in the Canadian PPSAs.72 It is not readily apparent why a buyer or lessee should not be able to rely on the rule just because they acquire the personal property as inventory, particularly given the broad meaning that is given to that term in s 10, and my view is that this restriction on the operation of s 44 should be removed.

Proposed recommendation 2.34: That s 44(2)(a) be deleted.

5.4.2.1.3 What types of serial-numbered property should s 44 apply to?

The taking free rule in s 44 applies to all types of property that may or must be described by serial number in a registration. In that respect the rule is consistent with the corresponding rule in the Canadian PPSAs and the NZ PPSA. However, the Canadian PPSAs and the NZ PPSA have a much narrower concept of property that may or must be described by serial number in a registration. None of them extends it to aircraft, watercraft or intellectual property, for example, and in New Zealand the concept is limited just to motor vehicles.

In my view, there is merit in considering whether s 44 should also be limited to just motor vehicles. At the moment, secured parties with a security interest over any serial-numbered property need to make specific registrations against each serial number, or risk losing their security under s 44. This can lead to the need to make large numbers of registrations, adding to the clutter on the Register.

I can see why it can be appropriate to provide that a person who is looking to buy or lease a motor vehicle should be able to rely just on a search against the serial number of the motor vehicle. Section 44 will most commonly apply to private sales or leases, and it would not be appropriate to expect the purchaser or lessee under such a sale or lease to undertake a full search against the grantor in order to determine whether the motor vehicle was subject to a security interest. Such sales or leases can happen at very short notice, and the buyer or lessee is unlikely in any event to be able to interpret the results of a full search.

The other types of serial-numbered property are however all business assets. A buyer or lessee of these types of assets is likely to be acquiring the asset for a business themselves, and the probable value and timeframe of the transaction are such that it might not be inappropriate to expect the buyer or lessee to undertake a full search of the seller or lessor before completing the transaction.

I am tempted to recommend for these reasons that we follow the approach in New Zealand, and limit the operation of the taking free rule in s 44 to motor vehicles. I would be interested to receive comments on this.

71 NZ PPSA, s 55.
72 Eg Sask PPSA, ss 30(6) and (7).
Proposed recommendation 2.35: None at this stage, pending further consideration.

5.4.2.2 Section 45(1) – the "day and a half" rule

Section 45(1) re-enacts a version of the "day and a half" rule that applied in relation to motor vehicles in some states and territories before the Act commenced operation. It provides that a buyer or lessee of a prescribed type of motor vehicle may take the motor vehicle free of a security interest if, among other things:

(a) the regulations provide that motor vehicles of that kind may, or must, be described by serial number; and

(b) there is a time during the period between the start of the previous day and the time of the sale or lease by reference to which a search of the register (by reference otherwise only to the serial number of the motor vehicle) would not disclose a registration that perfected the security interest; and

There is no corresponding provision in the Canadian PPSAs or the NZ PPSA.

The section is designed to assist the purchase of motor vehicles outside normal business hours, by allowing a purchaser to undertake a search against the serial number up to one and a half days before completing the purchase (as the purchase could then happen at night or on a weekend, when a register might otherwise be closed).

One of the great advantages of the Register, of course, is that it does not close on weeknights or on weekends, and a prospective purchaser of a motor vehicle can now do a search at any time. This suggests that s 45(1) might no longer be necessary, and I am inclined to recommend that it be deleted. As an alternative, the rule could perhaps be amended so that it only operates in favour of individuals. I would be interested to hear views of others on this.

Section 45(1) is also subject to a range of qualifications, in ss 45(1)(c) and 45(2). The purpose (and in some respects the meaning) of some of those qualifications is unclear. If s 45(1) is retained, then it would be desirable to simplify it, by rationalising or clarifying the purpose and meaning of some of those qualifications. This should include the removal of the carve-out for persons who buy or lease the motor vehicle as inventory, for the same reasons as discussed above in Section 5.4.2.1.2.

Proposed recommendation 2.36: None at this stage, pending further consideration.

5.4.2.3 Section 45(3) – prescribed dealers

Section 45(3) enables a buyer or lessee of a prescribed kind of motor vehicle to buy or lease the motor vehicle free of a security interest in the motor vehicle, if the seller or lessor is a member of prescribed class of persons. Regulation 2.2 prescribes the relevant class to be licensed motor vehicle dealers.

Similar to ss 45(1) and 45(2), this taking free rule is not available if the buyer or lessee holds the motor vehicle as inventory. I do not see why that is necessary, and am inclined to recommend that this qualification on the operation of the rule be removed.

Proposed recommendation 2.37: That s 45(4)(c) be deleted.

73 See eg the Chattel Securities Act 1987 (Vic), s 7(1A).
5.4.3 **Section 46 – transactions in the ordinary course of business**

Section 46(1) provides that a buyer or lessee of personal property takes the personal property free of a security interest given by the seller or lessor, or that arises under a section 32, if the personal property "was sold or leased in the ordinary course of the seller's or lessor's business of selling or leasing personal property of that kind". The Canadian PPSAs\(^ {74}\) and NZ PPSA\(^ {75}\) contain a similar provision.

This is probably the most important of all the taking free rules. Section 46(2) provides however that the taking free rule cannot be relied on if the personal property is serial-numbered property, and the buyer or lessee holds the personal property as inventory. This qualification is not found in any of the Canadian PPSAs or the NZ PPSA. In my view the qualification is not appropriate, and should be deleted.

**Proposed recommendation 2.38:** That s 46(2)(a) be deleted.

The taking free rule in s 46(1) also only applies in relation to security interests that are given by the seller or lessor, or that attach to personal property as proceeds under s 32. This limitation is consistent with the corresponding provision in the Canadian PPSAs and the NZ PSA. It does however erode the value of the taking free rule for a buyer or lessee. It means that the rule would not apply, for example, if the personal property was subject to a security interest that had been granted by a person other than the seller or lessor, and who then transferred the personal property to the seller or lessor in a manner that allowed that security interest to remain attached to the personal property. Section 46(1) will not allow the buyer or lessee to take the property free of that security interest, because it was not given by the seller or lessor.\(^ {76}\)

There is clearly a need here to choose between protecting the holder of the original security interest, and the person who buys or leases the personal property from the intermediate seller or lessor. The decision in Canada and New Zealand appears to have been to favour the interest of the secured party over that of the buyer or lessee. I am not convinced, however, that that is the most appropriate choice. I would be interested to hear views of others on this.

**Proposed recommendation 2.39:** None at this stage, pending further consideration.

Finally, one submission suggested that the taking free rules should not overlap, and in particular that s 46 should be limited to goods, rather than personal property generally. This would be consistent with the corresponding provision in the Canadian PPSAs and the NZ PSA.

I do not see any difficulty in having overlap between some rules, and limiting s 46 to goods would not eliminate all potential overlaps in any event. I would however be interested to hear whether others believe that this option should be pursued.

5.4.4 **Section 47 – the "low-value personal-use property" taking free rule**

Section 47(1) recognises that it may not be practicable or appropriate to expect a person to search the register before acquiring personal property, if that person is

\(^ {74}\) Eg Sask PPSA, s 30(2).
\(^ {75}\) NZ PSA, s 53.
\(^ {76}\) The buyer or lessee may however be able to take free under s 52, because the security interest is only temporarily perfected.
(broadly put) a consumer, and the personal property has only a modest value. The section provides:

(1) A buyer or lessee of personal property, for new value, that the buyer or lessee intends (at the time of purchase or lease) to use predominantly for personal, domestic or household purposes takes the personal property free of a security interest in the property if the market value (worked out at the time each part of the total new value is given) of the total new value given for the personal property is not more than:

(a) $5,000; or

(b) if a greater amount has been prescribed by regulations for the purposes of this subsection—that amount.

(c) at the time the contract or agreement providing for the sale or lease is entered into, the buyer or lessee believes, and it is actually the case, that the market value of the personal property is more than:

(i) $5,000; or

(ii) if a greater amount has been prescribed by regulations for the purposes of this paragraph—that amount.

A similar provision can be found in the Canadian PPSAs\(^\text{77}\) (other than the Ontario PPSA) and the NZ PPSA.\(^\text{78}\)

This taking free rule, as noted above, is designed to protect consumers. However, it is crafted in a way that many consumers could struggle to understand, and seems more complex than necessary. For example, the value assessment under s 47(1) could be made just once (when the agreement to buy or lease is entered into), rather than each time part of the consideration is paid, and the words "and is actually the case," could be deleted from s 47(2)(c) without significant impact.

One submission pointed out that it is perhaps unfair to punish a buyer or lessee who spots a bargain, unless the discrepancy between the sale price and the real value is so great that the buyer or lessee should be alerted to the fact that something may be wrong (and so should make further enquiries). At the moment though, the section disengages as soon as the market value of the personal property exceeds $5,000, even if only by a small amount. It might be appropriate for this reason to put a higher dollar amount in s 47(2)(c)(i) than in s 47(1)(a).

**Proposed recommendation 2.40:** That the taking free rule in the s 47(1) be amended as described above.

### 5.4.5 Section 50 – investment instruments

Section 50 provides that a purchaser (broadly defined) of an investment instrument will take the investment instrument free of a security interest if the purchaser gives value, and takes possession or control. There is an equivalent provision in the Canadian PPSAs,\(^\text{79}\) but not in the NZ PPSA.

\(^{77}\) Eg Sask PPSA ss 30(3) and (4).

\(^{78}\) NZ PPSA s 54.

\(^{79}\) Eg Sask PPSA s 31.1.
It is not immediately apparent why this taking free rule is necessary. It is not necessary for CHESS securities (both because CHESS securities are intermediated securities rather than investment instruments, and because they are covered in any event by s 49), so it is really only relevant to off-market transactions. And it is not clear why an off-market purchaser of an investment instrument should enjoy a protection that is not available to a purchaser of other types of personal property, such as goods. I would be interested to hear of reasons why s 50 should be retained. My current view is that we should adopt the New Zealand approach, and that s 50 should be deleted.

If the section is retained, then it should be clarified whether it is intended to operate in favour of another secured party. The language of s 50(1) suggests not, but ss 50(3) and 42(b) suggest otherwise. This uncertainty is undesirable.

Proposed recommendation 2.41: That s 50 be deleted.

5.4.6 Section 51 – intermediated securities

Section 51(1) provides that a person who takes an interest in an intermediated security will take the interest free of a security interest if:

(a) the transferee gives value for the interest (unless the interest acquired is itself a security interest); and

(b) the credit of the interest in the financial product in relation to which the intermediated security arises is made in accordance with a consensual transaction.

It is quite difficult to align this provision with the mechanisms by which intermediated securities are in fact held and dealt with. When the holder of an intermediated security "transfers" its intermediated security, it is in fact not transferring anything, in the strict sense. Rather, it informs its intermediary to debit its securities account by the agreed number of nominated financial products, in return for the intermediary agreeing to credit a corresponding number of those financial products to the securities account of the transferee. The transferee does not take an interest in the intermediated security at all.

It is also difficult to apply the section to a transfer of securities through the CHESS system, but that is not so important because those transfers will be able to rely on the taking free rule in s 49.

In any event, it is not readily apparent why a transferee of an intermediated security in an off-market transaction should enjoy a protection that is not available to buyers or lessees of other types of personal property. The provision appears likely to force secured parties to perfect by control, as that would be the only method by which a secured party could defend its security interest against the risk that a transferee could take free under the section.

There may be an argument that the nature of intermediated securities is such that a taking free rule along these lines is appropriate. I would be interested to hear further views on this.

If the provision is retained, it would be desirable to clarify the effect of s 51(1)(b). As one of the submissions pointed out, it would also be important to clarify whether

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80 Either directly (if the transferee is also a customer of that intermediary), or via another intermediary.
s 51(1) can be relied upon by another secured party – s 51(1)(a) suggests not, but s 42(b) suggests otherwise.

**Proposed recommendation 2.42:** None at this stage, pending further consideration.

### 5.4.7 Section 52 – temporarily perfected security interests

Section 52 provides as follows:

**Main rule**

(1) A buyer or lessee, for new value, of the proceeds of personal property, or of goods or a negotiable document of title, takes the proceeds, goods or document free of a security interest that is temporarily perfected by force of this Act (other than a transitional security interest perfected by force of section 322) immediately before the time of the sale or lease, if the security interest is not otherwise perfected at that time.

Note: Section 322 provides for the perfection of transitional security interests.

**Exception**

(2) Subsection (1) does not apply if the buyer or lessee has actual knowledge that the sale or lease constitutes a breach of the security agreement that provides for the security interest at:

(a) the time new value is first given for the sale or lease, if the personal property is bought or leased with the intention of using it predominantly for personal, domestic or household purposes; or

(b) in any other case—the time of sale or of entry into agreement for the lease.

As noted in Section 4.4.1 above, there are some circumstances in which the Act deems a security interest to be perfected for a temporary period of time. This deemed temporary perfection assists the secured party, but does not publicise the existence of the security interest in the same way as registration, perfection or control. Section 52 responds to this by providing that a buyer or lessee for new value of some types of collateral can take free of a security interest that is only temporarily perfected.

It is not clear why s 52 is limited to collateral that is proceeds, goods or a negotiable document of title. It is possible that this list was intended to reflect the types of collateral that can be subject to one of the temporary perfection rules, but if that is the case then the drafting of s 52 did not keep up with the drafting of the temporary perfection sections. In any event, it should be sufficient (and would be simpler and easier to understand) if s 52(1) simply referred to "personal property".

It must also be asked whether the complexity of s 52(2) is necessary. The intent behind s 52(2)(a) appears to be that a buyer or lessee that intends to use the property predominantly for personal, domestic or household purposes will be protected by s 52 if it did not have the requisite knowledge at the time it made the first payment (which could be a deposit) for the property. It seems to me however that all buyers or lessees would be served equally well if s 52(2) simply provided that the rule is available if the buyer or lessee did not have the requisite knowledge at the time they committed to the purchase or lease – that is, when they entered into the agreement to buy or lease the property. The Act could be simplified without adverse effect if s 52 were amended in this way.

**Proposed recommendation 2.43:** That s 52(1) be amended by replacing the references to proceeds, goods or negotiable documents of title with references to "personal property", and that s 52(2) be amended so that any buyer or lessee can
5.4.8 **Section 69 – creditor who receives payment of a debt**

Section 69 provides as follows:

1. The interest of a creditor who receives payment of a debt owing by a debtor through a payment covered by subsection (3) has priority over a security interest (whether perfected or unperfected) in:
   (a) the funds paid; and
   (b) the intangible that was the source of the payment; and
   (c) a negotiable instrument used to effect the payment.

   Example: A bank account from which the funds were paid is an example of an intangible that was the source of the payment.

2. Subsection (1) does not apply if, at the time of the payment, the creditor had actual knowledge that the payment was made in breach of the security agreement that provides for the security interest.

3. Payments made by a debtor are covered by this subsection if they are made through the use of:
   (a) an electronic funds transfer; or
   (b) a debit, transfer order, authorisation, or similar written payment mechanism executed by the debtor when the payment was made; or
   (c) a negotiable instrument.

A similar provision can be found in the Canadian PPSAs\(^81\) and the NZ PPSA.\(^82\)

Section 69 is currently framed as a priority rule. It is not clear what the justification for that is, and my view is that it may make more sense to treat s 69 as a taking free rule than as a priority rule, and relocate it to Part 2.5.

More substantively, the language of s 69 closely follows the corresponding provision in the Canadian PPSAs and the NZ PPSA, and as a result uses some terminology that may not be particularly relevant in Australia. This should be clarified. As one of the submissions suggested, it would also be worth exploring whether the language of the section could be aligned more closely with s 48, so that the same taking free principles could apply whether money was transferred in physical or electronic form. I would be interested to hear the views of others on this.

**Proposed recommendation 2.44:** That the language of s 69 be tailored more closely to Australian market conditions, and that it be explored whether the rules in ss 48 and 69 can be more closely aligned.

5.4.9 **Section 70 – negotiable instruments**

Section 70(2) provides that a person who acquires an interest in a negotiable instrument may have priority over a perfected security interest in the negotiable instrument, if, among other requirements, the person gave value for the interest and took possession or control.

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\(^81\) Eg Sask PPSA, ss 31(2) and (3).

\(^82\) NZ PPSA, s 95.
The term "negotiable instrument" is defined in s 10 in this way:

**negotiable instrument** means:

(a) a bill of exchange (within the meaning of the Bills of Exchange Act 1909); or
(b) a cheque (within the meaning of the Cheques Act 1986); or
(c) a promissory note (within the meaning of section 89 of the Bills of Exchange Act 1909); or
(d) any other writing that evidences a right to payment of currency, if:
   (i) the writing is of a kind that, in the ordinary course of business, is transferred by delivery with any necessary endorsement or assignment; or
   (ii) the writing satisfies the requirements for negotiability under the law governing negotiable instruments (including, but not limited to, instruments that are negotiable instruments within the meaning of this definition); or
(e) a letter of credit that states that it must be presented on claiming payment;

but does not include any of the following:

(f) the creation or transfer (including a successive transfer) of a right to payment in connection with interests in land, if the writing evidencing the creation or transfer does not specifically identify that land;

(g) a document of title;

(h) an intermediated security.

Paragraphs (a) to (c) of the definition, together with paragraph (d)(ii), are reflective of the general law understanding of the term "negotiable instrument". The remaining paragraphs, however, take the defined meaning well beyond the meaning given to the term on general principles. In doing so, the definition follows the Canadian PPSAs and the NZ PPSA. It does however make the Act harder to follow.

It is not clear whether this approach was taken as a drafting convenience, or whether some deeper policy issue was at play. I would be interested to hear whether others have any insight into this. Unless there is a good policy reason for defining the term in this rather counter-intuitive way, my inclination is to recommend that it be brought back into line with the general law understanding of the term.

As for s 70 itself it must be asked whether it is even needed. To the extent that the defined term "negotiable instrument" reflects the general law meaning, then s 70 essentially replicates the "holder in due course" rules from the Bills of Exchange Act 1909 and the Cheques Act 1986. Those rules are already preserved by s 256 of the Act. To the extent that the defined term goes beyond the general law meaning, it must be asked why s 70 is appropriate. Again, I would be interested to hear the views of others on this.

**Proposed recommendation 2.45:** None at this stage, pending further consideration.

5.4.10 **Section 71 – chattel paper**

As discussed in Consultation Paper No. 1, my view is that this section, and the concept of chattel paper generally, should be deleted from the Act.

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83 Eg Sask PPSA, s 2(1)(v).
84 NZ PPSA, s 16.
85 Consultation Paper No. 1, Section 4.2.2.
5.4.11 **Section 72 – negotiable documents of title**

Section 72 provides:

The interest of a holder of a negotiable document of title has priority over a perfected security interest in the document of title if:

(a) the holder gave value for the document of title; and

(b) the holder:

(i) in the case of a holder who acquired the document of title in the ordinary course of the holder's business of acquiring documents of title of that kind—acquired the interest without actual or constructive knowledge that the acquisition constitutes a breach of the security agreement that provides for the security interest; or

(ii) otherwise—acquired the document of title without actual or constructive knowledge of the security interest.

There is a similar provision in the Canadian PPSAs\(^{86}\) and the NZ PPSA.\(^{87}\) The section effectively repeats, in relation to negotiable documents of title, the rule for negotiable instruments in s 70 that is discussed in Section 5.4.9 above.

I am not aware that there has been any discussion of the appropriateness of this rule. I would be interested to hear views on this.

**Proposed recommendation 2.46:** None at this stage, pending further consideration.

5.4.12 **Section 53 – subrogation**

Section 53 applies where a person (the *transferee*) acquires personal property from another person (the *transferor*), and the transferee takes the personal property free of a security interest because of the operation of Part 2.5. Section 53(2) provides:

(2) The rights of the secured party are subrogated, in relation to the property, to the rights (if any) of the transferor and any predecessor of the transferor (including the right to receive any part of the purchase price for the property which has not been paid).

There is no corresponding provision in the Canadian PPSAs or the NZ PPSA. Rather, the provision appears to have been drawn from the *Chattel Securities Act 1987* (Vic).\(^{88}\)

The drafting of s 53(2) is somewhat curious. In my view it should be the "secured party", not the "rights of the secured party" that is subrogated. Also, it is not clear what would happen if there were more than one security interest over the personal property, and the transferee had taken free of both (or all) of them. Are they all subrogated to the transferor's rights to receive payment of the purchase price? If so, on what basis?

More importantly though, it is not clear what the section adds to s 32. The right to receive payment of the purchase price for the transferred personal property will be proceeds of the personal property under s 31, and the secured party will acquire an interest in the right to receive the purchase price because its security interest will

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\(^{86}\) Eg Sask PPSA, s 31(5).

\(^{87}\) NZ PPSA, s 99.

\(^{88}\) *Chattel Securities Act 1987* (Vic), s 7(7), prior to repeal of the section as of 30 January 2012.
attach to the right as proceeds, under s 32(1)(b). I do not see how s 53 adds any material value to the Act, and believe that it could be deleted. I note however that one submission attached some importance to the role of s 53, and so would be interested to hear whether others agree.

**Proposed recommendation 2.47:** That s 53 be deleted.

5.4.13 **Section 37 – reattachment of a security interest**

If a person buys an item of collateral and takes it free of a security interest, then the effect of the taking free rule will be to extinguish the security interest. If the person acquires the collateral by way of lease rather than buying it, however, the security interest may not be extinguished. Rather, the security interest may simply become subject to the lease, and the secured party will only be able to enforce its security interest in a manner that does not disturb the lessee's right under the lease.

Section 37(1) provides as follows:

(1) If a grantor or debtor sells or leases goods that are subject to a security interest, and the buyer or lessee takes the goods free of the security interest because of the operation of this Act, the security interest reattaches to the goods at a particular time (the repossession time) if, at that time, the goods come into the possession of the grantor or debtor, or of a transferee of chattel paper created by the sale or lease, in any of the following circumstances:

(a) in the case of a sale—the contract of sale is rescinded;
(b) in the case of a lease—the lease expires or is rescinded;
(c) the transferee seizes the goods in the exercise of a right in enforcing a security agreement;
(d) the grantor or debtor repossesses the goods in the exercise of a right in enforcing the contract of sale or the lease;
(e) any other circumstances prescribed by the regulations.

A similar provision can be found in the Canadian PPSAs, but not in the NZ PPSA.

Section 37(1) appears to assume that the effect of a sale or lease of goods that allows the buyer or lessee to take free of a security interest is that the security interest "detaches" from the goods. While that will be the case for a sale, it will not necessarily be the case for a lease. If goods are leased in a way that does not cause the lease to be characterised as a security interest (if a car is rented out over the weekend, for example), then a security interest over the goods should clearly remain attached to the goods even during the term of the lease.

If the lease gives rise to a security interest, different considerations may apply. This will depend on whether a lease that is a security interest is treated by the Act as a transfer of the leased goods from the lessor to the lessee. This question is related to the issues that were discussed in Section 5.2 above. If it is a transfer, then it would be appropriate to accept that the taking free rule causes the security interest to detach (in the same way as it would for a sale), so that it could then re-attach under s 37 in the circumstances contemplated by the section. If such a lease is not a transfer, however, then s 37 should not imply that the taking free rules cause a security interest in the leased goods to detach in the first place.

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89 Eg Sask PPSA, s 29(1).
90 For an explanation, see Gedye Cuming & Wood, page 217.
One submission also suggested that s 37 should apply to a security interest that ceased to be attached to collateral as a result of a dealing subject to s 32. If s 32 is amended as discussed in Section 5.3, however, then this may be less necessary. I would be interested to hear views on this.

One academic paper,91 has also pointed out that the drafting of ss 37 and 38 focuses too heavily on the treatment of chattel paper, to the detriment of other secured financing techniques.

**Proposed recommendation 2.48:** That s 37 be amended to make it clear that it only applies if the effect of the buyer or lessee taking the goods free of a security interest is that the security interest ceases to be attached to the goods, and that ss 37 and 38 be amended to ensure that they apply appropriately for all types of security interests.

### 5.4.14 Interaction with taking free rules outside the Act

While Commonwealth legislation was amended to accommodate the implications of the Act, the same did not happen to the same extent at the state and territory level. As one example, legislation in all states and territories continues to provide that a buyer in possession of goods, or a mercantile agent, can dispose of goods even though they do not have title.92 It is not clear whether these provisions continue to operate despite the commencement of the Act, or whether those rules are not capable of "operating concurrently" with the Act, in which case they will no longer apply, to that extent.93

My view is that the taking free rules in the Act do not need to be an exhaustive code, and that additional taking free rules outside the Act should be able to continue to apply. I would however be interested to hear the views of others on this.

**Proposed recommendation 2.49:** None at this stage, pending further consideration.

### 5.5 Accessions

#### 5.5.1 Potential overlap with Part 3.4

One submission pointed out that there is potential for overlap between Part 3.3 (dealing with accessions) and Part 3.4 (dealing with processed and commingled goods). The submission gave the example of paint sprayed onto a car body as goods that could be regarded as being both an accession (as defined in s 10) and goods that have been so processed that they have lost their identity in the product (ie the car).

The tenor of Part 3.3, dealing with accessions, is that an accession is something that remains capable of being removed from the whole. On that basis, the paint sprayed onto a car body is not an accession. Instead, the paint has lost its separate identity, and so is processed goods and subject to Part 3.4.

I agree however that it would be helpful to clarify the interaction between the two sets of rules. The potential for confusion would be eliminated if the definition of "accession" in s 10 were expanded to make it clear that goods are not an accession if they have lost their identity in a product and so are covered by Part 3.4.

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92 For example, ss 31 and 67 of the *Goods Act 1958* (Vic).

93 Under s 254(1) of the Act.
Proposed recommendation 2.50: That the definition of “accession” in s 10 be amended to clarify that goods will not be an accession to other goods if their identity has been lost in the other goods in a way that engages the application of Part 3.4 of the Act.

5.5.2 Terminology – "continues in"

Part 3.3 of the Act contains a number of provisions dealing with security interests in accessions. A number of those provisions refer to the fact that a security interest in goods that become an accession can “continue in” the accession. As discussed in Section 5.3.2 above, it is my view that “continues in” is likely to mean the same as “remains attached to”, and that it could make the Act easier to work with if the references in the Act to a security interest “continuing in” collateral were to be amended accordingly.

Proposed recommendation 2.51: That references in Part 3.3 of the Act to a security interest "continuing in" collateral be amended to refer to the security interest "remaining attached to" the collateral.

5.5.3 Section 90 – competitions with an interest in the whole

Section 90 sets out some circumstances in which a person's interest in the whole can take priority over a security interest that had attached to goods before they became an accession. They include the interest of:

(a) a person who acquires for value an interest in the whole after the goods become an accession, but before the security interest in the accession is perfected;

(b) an assignee for value of a person with an interest in the whole at the time when the goods become an accession, but before the security interest in the accession is perfected;

It is difficult to see what paragraph (b) adds to paragraph (a), as an assignee of a person with an interest in the whole (under paragraph (b)) will necessarily be acquiring an interest in the whole (under paragraph (a)). In my view, s 90(b) could be deleted.

Proposed recommendation 2.52: That s 90(b) be deleted.

5.5.4 Comments in submissions

None of the submissions raised any concerns regarding Part 3.3 of the Act, other than regarding a secured party's ability to remove an accession from the host goods on enforcement. That issue will be dealt with in a later consultation paper.

5.6 Processed and commingled goods

5.6.1 Should processed and commingled goods be dealt with separately?

Part 3.4 of the Act contains rules that deal with a situation where goods that are subject to a security interest are commingled with other goods, or are so manufactured, processed or assembled that they lose their identity in an end product.

As one of the submissions noted, it must be asked whether it is appropriate to apply the same rules to both processed and commingled goods. It has been pointed out with
some force\textsuperscript{94} that the rules in Part 3.4 appear to have been designed principally with processed (rather than commingled) goods in mind, and that they can produce unfair outcomes when applied to goods that are commingled.

My view is that this concern should be addressed, and that Part 3.4 should be recast so that there are separate rules for each of processed and commingled goods. This would add modestly to the length of the Act, but would produce fairer outcomes for secured parties with a security interest in commingled goods than is the case at present.

Under such an approach, the current rules in Part 3.4 would continue to apply (subject to the comments below) to processed goods. In contrast, the rules for commingled goods could be based on the principle that a party with an interest in goods that are commingled into a larger bulk should share in that larger bulk in the proportion that its goods represents of all contributions to the bulk. To the extent that more than one party had an interest in goods that become part of a larger bulk, their rights as against each other would continue to be resolved as if the goods were still separate, but on the basis that the aggregate of their claims could not exceed the relevant proportion of the bulk, as described in the previous sentence. If a secured party wants to enforce its security interest in a share of the bulk, it would need to separate the relevant share from the bulk, and then enforce against that separate share.

I would be interested to hear whether such an approach is thought to be appropriate.

One submission suggested that the provisions dealing with commingled goods should also apply to the commingling of fungible intangibles as well. Again, I would be interested to hear the view of others on this.

\textbf{Proposed recommendation 2.53:} That Part 3.4 of the Act be split into two, and that commingled goods be dealt with separately, in accordance with the principles described above.

\section*{5.6.2 Deemed perfection}

The balance of this Section 5.6 relates to Part 3.4 as it applies to processed goods. As suggested above, commingled goods should be dealt with separately.

Section 100 provides:

For the purposes of section 55 (default priority rules), perfection of a security interest in goods that subsequently become part of a product or mass is to be treated as perfection of the security interest in the product or the mass.

This provision is similar to s 32(5), which was discussed in Section 5.3.7. For reasons similar to those given in Section 5.3.7, it must be asked whether s 100 should apply more broadly, and not just in relation to the default priority rules in s 55. If ss 102 and 103 are amended along the lines discussed immediately below, it might even be appropriate to apply the rule in s 100 for all purposes of the Act. I would be interested to hear the views of others on this.

\textbf{Proposed recommendation 2.54:} None at this stage, pending further consideration.

5.6.3 Resolving competitions between security interests

5.6.3.1 Competition with a security interest over the whole

Section 101 states:

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

Section 32(2) deals with a similar issue, in relation to proceeds. Unlike s 101, however, s 32(2) does not just limit the security interest's priority over other security interests. Rather, it limits the amount recoverable under the security interest.

The relevance of this can be explained with a slightly-modified version of an example from one of the submissions:

$40,000 worth of woodchips is mixed with $10,000 worth of resin to make $100,000 worth of chipboard. There is a perfected security interest over the woodchips securing $50,000, and an unperfected security interest over the finished chipboard securing $20,000.

Section 101 limits the priority held by the woodchips security interest to $40,000. Because the section does not limit the amount recoverable, however, the secured party can also rely on its security interest to recover the remaining $10,000 out of the sale proceeds from the chipboard after the $20,000 has been paid to the holder of the unperfected security interest. And the secured party would have been able to recover its $70,000 without interference if it had been the only secured party with a security interest over the chipboard (for example, if the grantor had gone into insolvency, and the unperfected security interest had vested in the grantor under s 267).

This appears to give the secured party a windfall. One submission suggested this was appropriate. I would be interested to hear whether others agree, or whether the section should instead operate as a cap on the amount recoverable.

One submission also queried how s 101 would operate if the security interest was over both the woodchips and the chipboard. Would s 101 limit the secured party's reliance on its security interest over just the woodchips, or its security interest over the chipboard itself?

The better view is that s 101 would not limit the secured party's ability to rely on its security interest over the chipboard. I accept that this is not beyond doubt, but do not think it is necessary that the Act be amended to confirm this. Instead this explanation, if included in my formal report, may be extrinsic material of a type referred to in s 15AB(2)(b) of the Acts Interpretation Act 1901, and so available to assist in the interpretation of the Act.

The same submission queried whether it was appropriate to set the value of the goods by reference to the date on which they were processed. If the goods in question are gold, for example, would it be more appropriate to set their value by reference to the price of gold as at the day the processed goods are sold in the relevant enforcement proceedings? I would be interested to hear views on this.

Proposed recommendation 2.55: None at this stage, pending further consideration.

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95 Section 32(2) is discussed further in Section 5.3.6 above.
5.6.3.2 **Competition with another continuing security interest**

Section 102(2) provides, where more than one perfected security interest continues in a product that results from processed goods, that the perfected security interests share in the product in proportion to their amount secured. Section 102(3) contains a similar rule for multiple unperfected security interests.

It is not clear that these rules are appropriate. If the competing security interests had originally been over the same property that then became part of their product, they should share in the same way as they would have shared if the goods had not been processed. The aggregate amount that they could recover would be limited however to the value of those goods on the day that they became part of the product. To this extent, the rules would be similar to the rules suggested in Section 5.5.2 above for commingled goods.

The Act does not expressly explain how to resolve a competition between a security interest over an input, and a security interest that has been separately taken over the product. Section 101 (discussed above) limits the extent to which the security interest over the input can have priority, but does not explain whether it has priority in the first place.

In my view, the correct approach should simply be to allow the general rules of the Act to apply. If a security interest over an input was perfected before a security interest taken over the whole product, then the security interest over the input should prevail (subject to the limitation that its priority is capped at the value of the input). If the security interest over the whole was perfected first, then it takes priority (with no cap on the priority amount). If one of the security interests was a purchase money security interest and had priority under s 62, though, it would take priority over the other security interest (again, subject to the cap, in the case of the security interest over the input).

This would address, among other things, the points raised in submissions about the potentially anomalous operation of s 103.

Sections 102(2) and (3) also create uncertainty because they have the effect that secured parties can find themselves ranking equally with each other. In this situation, which secured party gets to control enforcement proceedings? The answer to this question may simply need to be that it depends on who seizes the collateral first. I would however be interested to hear whether there might be alternative solutions to this problem.

**Proposed recommendation 2.56:** That ss 102 and 103 be amended to reflect the principles set out above.

5.7 **Proceeds**

5.7.1 **Grantor must have an interest in the proceeds**

Section 31(3)(a)(i) provides that personal property will only be proceeds if (among other options):

(i) the grantor has an interest in the proceeds; ...

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96 Or possibly on the day the product is sold on enforcement. See the last paragraph of Section 5.6.3.2.
There is a similar provision in most of the Canadian PPSAs\(^\text{97}\) and the NZ PPSA.\(^\text{98}\)

The following example may help to understand the effect of this requirement.

A secured party has a security interest in a grantor's motor vehicle. The grantor sells the motor vehicle to a buyer without the secured party’s consent. The buyer cannot rely on the taking free rules, so the security interest remains attached to the motor vehicle. The buyer later exchanges the motor vehicle for a caravan.

The effect of s 31(3)(a)(i) can be understood in at least two ways. First, it can be understood to mean that the security interest does not attach to the caravan, even though the caravan derives from a dealing in the motor vehicle, because the grantor does not have an interest in the caravan. Read in this way, the section is said to be designed to prevent a "geometric multiplication" of proceeds claims, and to limit the extent to which third parties could be prejudiced by the fact that it may not be apparent from the Register that a secured party holds a security interest in the property.\(^\text{99}\)

The provision can however be viewed in a different way. It is clear from other provisions in the Act that a transfer of collateral that is subject to a security interest can have the result that the transferee becomes the grantor of that security interest for the purposes of the Act. See Section 3.6 above. This means then that the buyer in the example becomes the grantor of the security interest in place of the original grantor. Seen that way, the security interest would attach to the caravan, as proceeds of the motor vehicle, because the grantor (ie the buyer) has an interest in it.

This way of approaching the issue also addresses the risk of undiscoverable security interests – that is, the risk that the buyer might sell the caravan to another person, who would be unable to discover the existence of the security interest, and so unwittingly not acquire clear title. It achieves this through the fact that the security interest will be unperfected. Even if the security interest was perfected against the original grantor by registration, that registration will have ceased to perfect the security interest when the motor vehicle was transferred to the buyer, because at that point the buyer became the grantor in place of the original grantor.\(^\text{100}\) The security interest will be temporarily perfected under s 34, but when the buyer exchanges the motor vehicle for the caravan the security interest in the motor vehicle will not have been perfected by registration. This means that the security interest in the caravan (as proceeds of the motor vehicle) will at best be temporarily perfected (and then only for a short period) under s 33(2), and after that will be unperfected. The later buyer of the caravan would take the caravan free of the security interest, under s 43 or 52.

Admittedly, this way of approaching the application of s 31(3)(a)(i) does raise the potential for a “geometric multiplication” of claims. One wonders, though, how often that would arise in practice. And this approach arguably has the advantage of fitting more neatly with other aspects of the Act’s conceptual framework.

It seems to me that both ways of approaching s 31(3)(a)(ii) can produce clear and rational outcomes. It would be helpful however to see whether there is a consensus as to which approach is thought to be preferable.

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\(^{97}\) Eg Sask PPSA, s 2(1)(hh)(i)(B).

\(^{98}\) NZ PPSA, s 16 (definition of "Proceeds", para (a)(ii)).

\(^{99}\) See Duggan & Brown, para 11.13.

\(^{100}\) This assumes that the secured party did not happen to have an appropriate registration against the buyer as well.
As a separate matter, s 31(3)(a)(i) refers to the grantor having "an interest in" the proceeds. This is different to the primary formulation that the Act uses in relation to the grant of security interests generally (under s 19(2)(a)), which requires that the grantor have "rights in" the collateral. In the context of the grant of a security interest, the Act uses the expression "interest in" collateral to refer to the interest of the secured party under the security interest, not the interest in the collateral that the grantor needs to have in order to be able to grant the security interest in the first place.

It is not clear to me why s 31(3)(a)(i) uses the expression "interest in", rather than "rights in". I would be interested to hear if others are aware of an explanation for this. If there is no good reason, my preference would be to amend the section to make it consistent with the terminology used in s 19. As a consequence, it may be necessary to extend the deeming provision in s 19(5) to apply to s 31(3)(a) as well.

**Proposed recommendation 2.57:** That the words "an interest" in s 31(3)(a)(i) be replaced with "rights", and that s 19(5) be amended to refer to s 31(3)(a) as well as s 19(2)(a).

5.7.2 **Grantor can instead have the power to transfer rights in the proceeds to the secured party**

Section 31(3)(a)(ii) provides, as an alternative to the grantor having an interest in the proceeds under s 31(3)(a)(i), that personal property can be proceeds if (among other requirements):

(ii) the grantor has the power to transfer rights in the proceeds to the secured party (or to a person nominated by the secured party); ...

The Act contains similar language in relation to the grant of a security interest over original collateral, in s 19(2)(a). The language in s 19(2)(a) was discussed in Section 2.3 above. For the reasons given there, I am of the view that s 31(3)(a)(ii) should be deleted.

**Proposed recommendation 2.58:** That s 31(3)(a)(ii) be deleted.

5.7.3 **Perfection of a security interest over proceeds**

5.7.3.1 **Description of the proceeds in the financing statement**

Section 33(1) provides that a security interest over proceeds is taken to be perfected if the security interest in the original collateral is perfected by a registration that:

(a) describes the proceeds, if the description complies with any regulations made for the purposes of paragraph (d) of item 4 of the table in section 153 (financing statements with respect to security interests); or

(b) covers the original collateral, if the proceeds are of a kind that are within the description of the original collateral; or

(c) covers the original collateral, if the proceeds consist of currency, cheques or an ADI account, or a right to an insurance payment or any other payment as indemnity or compensation for loss or damage to the collateral or proceeds.

A similar provision can be found in the Canadian PPSAs\(^{101}\) and the NZ PPSA\(^{102}\).

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\(^{101}\) Eg Sask PPSA, s 28(2).
Section 33(1) only perfects a security interest in proceeds if the security interest in the original collateral was perfected by registration, not if it was only perfected by possession or control. This is presumably on the basis that a secured party that has possession or control of the original collateral can ensure as necessary that it is perfected over any proceeds from the collateral as well.

The Regulations that were made for the purposes of item 4(d) of the table in s 153 allow proceeds to be described in a way that identifies the particular proceeds, that identifies a class to which the proceeds belong, or that simply describes the proceeds as "all present and after-acquired property". The Register accommodates all of these options, but makes "all present and after-acquired property" the default choice. A well-advised secured party would be highly unlikely to override the default choice with a different formulation.

It is not difficult to see why a secured party would like to use the "all present and after-acquired property" default option. At the time a secured party registers its financing statement, it is unlikely to know what the nature of any proceeds might be that the grantor might receive in the future from a dealing with the collateral. The default option removes that uncertainty for the secured party, and ensures that the security interest can be perfected over proceeds, whatever form they take. The downside to this approach however is that it diminishes the value of the information on the Register that is available for a searcher. This can be illustrated with an example.

A secured party has a security interest over a grantor's motor vehicle. The security interest is perfected by registration against the class "motor vehicle", and the registration describes the proceeds by using the "all present and after-acquired property" option. The grantor then exchanges the motor vehicle for a race horse.

The secured party's security interest will be automatically perfected over the race horse, even though this will not be apparent from the Register. If the grantor then tries to sell the horse, a prospective buyer will not be able to tell from a search of the Register that the horse is subject to the security interest.

It is difficult to conceive of an alternative approach that does not disadvantage either the secured party or the unwitting potential buyer, and it may be inevitable that one of them needs to be preferred over the other. I would however be interested to hear whether the current allocation of risk is thought to be appropriate.

One commentary on the Act makes the point, if the preferred approach is to continue to favour the secured party over the potential buyer, that it might be simpler to just provide that a security interest over proceeds is automatically perfected, if the security interest over the original collateral was perfected by registration. That is the de facto position under the current combination of s 33(1)(a), the Regulations and the default configuration of the Register. It is also the approach taken (more explicitly) under the Ontario PPSA. It would make the Act, the Regulations and the Register itself simpler if s 33 were amended to say this. It would then be possible to delete ss 33(1)(b) and (c) as well. Again, I would be interested to hear the views of others on this.

Proposed recommendation 2.59: None at this stage, pending further consideration.
5.7.3.2 **Description of the proceeds as original collateral**

Section 33(1)(b) provides that a security interest in proceeds will be perfected if the proceeds are within the description of the original collateral in the financing statement.

It is not clear that s 33(1)(b) is needed, even on the current formulation of s 33.\(^{106}\) If the proceeds are within the collateral description in the financing statement, then arguably the security interest over those proceeds is perfected on general principles, without the need for the deeming provision. If the provision is needed, though, it is too narrow, as it should allow the security interest in the proceeds to be perfected by **any** registration that the secured party has against the grantor, not just the same registration as for the particular original collateral. Using the example given in Section 5.7.3.1 above, if the secured party already had a separate registration against the grantor for the collateral class "Other goods", then its security interest should be perfected against the horse, even though that is a different registration to the one that perfected its security interest over the motor vehicle.

**Proposed recommendation 2.60:** That s 33(1)(b) be deleted or, if it is retained, that it be amended to make it clear that the security interest is perfected over the proceeds if the proceeds are within the collateral description of any current financing statement made by the secured party against the grantor, not just the same financing statement.

5.7.3.3 **Liquid proceeds**

Section 33(1)(c) provides that a security interest in proceeds is deemed perfected if the proceeds consist of currency, a cheque, an ADI account or a right to payment as compensation for loss or damage to the collateral or the proceeds.

The rationale for this rule is said to be that a person who acquires an interest in these types of personal property should realise that they could have arisen from a dealing in other property of the grantor, and that the other property could have been subject to a security interest that is perfected by a financing statement that could be found by searching the Register.\(^{107}\) I would be interested to hear whether this is thought to be an appropriate justification for this rule.

**Proposed recommendation 2.61:** None at this stage, pending further consideration.

5.7.3.4 **Temporary perfection**

If collateral that is subject to a perfected security interest is transferred, then the security interest is deemed by s 34(1) to be temporarily perfected over the transferred collateral for a period of time after the transfer.

One submission suggested that it was not clear that s 34 applies only to the security interest over the original collateral, and expressed the view that it could be read as applying to the security interest over the proceeds as well. The submission proposed that this be clarified.

In my view, it is clear that s 34 is only dealing with the security interest in relation to the original collateral, not in relation to the proceeds. Section 34 addresses the fact that a security interest that had been perfected by a registration, for example, would cease

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\(^{106}\) That is, if s 33(1) is retained in its current form. See Section 5.7.3.1.

\(^{107}\) Cuming Walsh & Wood, page 581.
to be perfected by that registration if the collateral is transferred, as the transfer would cause the transferee to become the "grantor" of the security interest (whereas the registration will have been made against the transferor). The temporary perfection period in s 34 protects the secured party by providing it with an opportunity to re-register before it becomes unperfected.

This protection is not needed for the proceeds, as the transfer does not cause a security interest over the proceeds to become unperfected – indeed, the transfer causes the security interest to attach to the proceeds in the first place. And the perfection of the security interest over the proceeds is dealt with separately, in s 33.

This could be put beyond doubt, however, by inserting "in the collateral" after "interest" in line 3 of s 34(1).

**Proposed recommendation 2.62:** That "in the collateral" be inserted after "interest" in line 3 of s 34(1).

5.7.4 **Other matters relating to proceeds**

Other questions relating to the treatment of proceeds under the Act are discussed elsewhere in this paper. See in particular Section 5.3 above.

5.8 **Sections 79 to 81**

5.8.1 **Section 79 – transfers of collateral despite a prohibition in the security agreement**

Section 79 provides in effect that a grantor of a security interest can transfer the collateral to a third party, even if the security agreement prohibits the transfer. This means, for example, that a lessee under a finance lease can transfer the leased goods (subject to the lease) to a third party, despite a prohibition on transfers in the lease agreement.

The lease agreement could still provide that the transfer was a default. However, the secured party lessor would need to enforce the default under the lease agreement against the transferee, not the original lessee.

There are equivalent provisions in some of the Canadian PPSAs, and the NZ PPSA. The section only deals with "transfers" of collateral. It does not clearly cover the grant of a security interest as well.

Section 79 differs from the position that applied, at least to some extent, under the general law before commencement of the Act (and that will continue to apply to dealings in property that are outside the section). I would be interested to hear whether the policy outcome produced by s 79 is thought to be appropriate and, if it is, whether it should apply to the grant of a security interest, in addition to transfers.

**Proposed recommendation 2.63:** None at this stage, pending further consideration.
5.8.2 **Section 80 – rights of parties on transfer of an account**

Section 80(3) provides that the transferor of an account can agree with the obligor on the account to amend the terms of the contract that gives rise to the account, even after the transfer, and whether or not the transferee agrees. A similar provision can be found in most of the Canadian PPSAs, but not in the NZ PPSA.

There are some restrictions on the extent to which the transferor can do this. In particular, the modification to the terms of the contract must not have a material adverse effect on the transferee's rights, or on the transferor's ability to perform on the contract. Despite this, s 80(3) might be seen to be an unnecessary erosion of a transferee's ability to control the terms of the account that it has purchased.

As discussed in Consultation Paper No. 1, the primary objective of the Act was to replace the rules that previously governed secured transactions with a single set of rules that applied consistently to all types of grantor and all types of property. While s 80 relates to the legal effectiveness of the terms of an account that is the subject of a security interest, it might be thought to stray beyond the Act's primary objective, in that the Act could achieve that objective perfectly well without including the section (which deals with a related but distinct topic).

To my knowledge, the policy behind s 80, and the reason for including it in the Act, have not been widely articulated. A leading Canadian commentary suggests that the purpose of the corresponding Canadian provisions is to allow for situations where a change in circumstances may make appropriate to allow the transferor to amend the contract, but it is not clear to me that this is a sufficiently compelling reason for including s 80, particularly as the transferee of an account in the Australian market would usually want to oblige the transferor not to amend the terms of the account without the transferee's consent.

I would be interested to hear whether s 80(3) is thought to be appropriate.

**Proposed recommendation 2.64:** *None at this stage, pending further consideration.*

5.8.3 **Section 81 – transfer prohibitions in a transferred account**

Section 81 allows accounts to be transferred in some circumstances even if the account itself contains a restriction or prohibition on transfers. A similar provision can be found in the Canadian PPSAs, but not in the NZ PPSA.

It might be asked whether it is appropriate to statutorily deny an account obligor the freedom of contract to determine who it should be obliged to make payments to. It could also be asked whether this is an appropriate provision to include in a secured transactions law, as it deals with matters of general contracts law, not just security.

There does seem to have been a clear trend internationally toward negating the effect of prohibitions on transfers of payment intangibles. In addition to the fact that provisions similar to s 81 can be found in the Canadian PPSAs, a similar provision is in Article 9, and legislation addressing the issue has recently been introduced into

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111 Eg Sask PPSA, s 41(3).
112 Cuming Walsh & Wood, pages 665 to 666.
113 Eg Sask PPSA, s 41(9).
114 Article 9, § 9-406(d).
Parliament in the United Kingdom. Provisions of this type can also be found in some international Conventions.

It may well be appropriate for Australia to follow this trend. Because the provision was included in the Act rather than in legislation that applies to contractual rights more generally, though, I am not confident that it will have been considered by all potential affected stakeholders. I would be interested to hear whether this is thought to be a concern.

If it is appropriate to retain s 81, then a number of drafting problems or other questions should be addressed. For example, the requirement in s 81(1)(b) that the term restrict or prohibit transfers "for currency due or to become due" arguably robs the section of most of its effect, as very few transfer restrictions are worded in this way. Secondly, it is not clear why s 81(1)(b)(ii) excludes accounts that arise from granting rights under construction contracts or from providing financial services. Thirdly, as one submission pointed out, the section should only invalidate the restriction on transfers to the extent that it relates to the account or chattel paper (if that concept is retained). And finally, it must be asked whether it makes sense to limit the section to "transfers", or whether it should apply to the grant of a security interest as well.

The meaning of "currency"

One submission suggested, in the context of s 81, that the definition of "currency" in s 10 be expanded, to include "money" in the commercial sense as well as currency in the strict sense of notes and coins.

The term "currency" is used in a number of places in the Act, not just s 81. My preference, if the limitation in s 81 is thought to be too restrictive, that this be dealt with in the context of the section, rather than by amending the definition of "currency" for all purposes of the Act.

**Proposed recommendation 2.65:** None at this stage, pending further consideration.

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116 The UNIDROIT Convention on International Factoring, Article 6, and the 2001 UN Convention on the Assignment of Receivables in International Trade, Article 18.3.
6. **THE PRIORITY RULES**

6.1 **When is priority determined?**

A grantor can grant more than one security interest in the same item of collateral. Part 2.6 of the Act provides rules to determine which of the security interests ranks ahead of the other, in such a situation – that is, which has the higher priority.

The Act does not specify when the priority determination is to be made. Most of the time this will not matter, as the relative priority position as between security interests will not normally change. It is not difficult however to conceive of circumstances where this would be possible. For example, a first-ranking security interest's registration could expire in the middle of the enforcement process. As another example, a PMSI financier could finance an asset but not register immediately, and if an earlier secured party with a perfected all-assets security enforces against the collateral before the PMSI financier has registered, the earlier secured party will have the superior priority position. If the PMSI financier then registers within the 15 business day period and so attains PMSI status, however, is it then able to take over conduct of the enforcement process because it now has the better priority?

The Canadian PPSAs and the NZ PPSA are also silent on this question. Case law in Canada and New Zealand has taken the view that priority is to be assessed by reference to the point in time at which the security interests "come into conflict" – which will usually be the time when one of the secured parties commences enforcement action, for example by seizing the collateral. That is however not the only option. It would also be possible to assess priorities when the collateral is realised, and a leading Canadian commentary argues that priority should be assessed even later, when the collateral has been realised and proceeds are available for distribution.\textsuperscript{117}

It would be helpful to clarify what point in time should be used to determine which of two or more competing security interests has priority. I lean towards recommending that it should be the time at which proceeds from the realisation of the collateral are available for distribution. I would however be interested to hear the views of others.

**Proposed recommendation 2.66:** None at this stage, pending further consideration.

6.2 **Section 55(2) - priority as between two unperfected security interests**

Section 55(2) states that the default priority rule as between two unperfected security interests over an item of collateral is that priority is determined by the order in which the security interests attached to the collateral. In most cases, this will be the order in which the secured parties entered into their security agreement with the grantor.

The Canadian PPSAs\textsuperscript{118} and the NZ PPSA\textsuperscript{119} contain a similar provision.

The rule in s 55(2) does not explain how priority is to be determined if both security interests attach at the same time – for example, if the security interests are over an

\textsuperscript{117} Cuming Walsh & Wood, pages 471 and 472.

\textsuperscript{118} Eg Sask PPSA, s 35(1)(c).

\textsuperscript{119} NZ PPSA, s 66(c).
item of collateral that the grantor does not acquire until after it has entered into both security agreements.

I believe the better view is that priority in this situation should be determined by the order in which the secured parties entered into their respective security agreements with the grantor. The Replacement Explanatory Memorandum suggests however that the security interests should rank equally. I think it would be helpful to remove this uncertainty, and to include an appropriate rule in the Act. My preference is to follow the general law position, and to rank the security interests by reference to the order in which the security agreements were entered into.

**Proposed recommendation 2.67:** That the Act be amended to make it clear that priority as between two unperfected security interests that attach to collateral at the same time is to be determined by the order in which the security agreements were entered into.

### 6.3 Section 55(5) – the "priority time" for a security interest

Section 55(4) states that the default priority rule as between two perfected security interests is that priority is determined by reference their respective "priority times". Section 55(5) explains how a security interest's priority time is determined, in this way:

(5) For the purposes of subsection (4), the priority time for a security interest in collateral is, subject to subsection (6), the earliest of the following times to occur in relation to the security interest:

   (a) the registration time for the collateral;
   
   (b) the time the secured party, or another person on behalf of the secured party, first perfects the security interest by taking possession or control of the collateral;
   
   (c) the time the security interest is temporarily perfected, or otherwise perfected, by force of this Act.

Provisions reflecting this principle can also be found in the Canadian PPSAs and the NZ PSA. The drafting of s 55(5) is somewhat convoluted. It may be able to be simplified, without compromising its effect, by condensing paragraphs (a), (b) and (c) into two paragraphs, so that the section reads like this:

(5) For the purposes of subsection (4), the priority time for a security interest in collateral is, subject to subsection (6), the earliest of the following times to occur in relation to the security interest:

   (a) the registration time for the collateral; and
   
   (b) the time at which the security interest becomes perfected.

This suggested drafting also has the advantage of avoiding the need to refer to the time at which a security interest was "first" perfected. That is helpful, because s 55(6) goes on to say that a time is only a priority time for a security interest if the security interest

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120 Replacement Explanatory Memorandum, para 2.110.
121 Eg Sask PSA, s 35(1)(a).
122 NZ PSA, s 66(b).
has been continuously perfected since that time. If a security interest was initially perfected, then became unperfected but was re-perfected some time later (for example, if the secured party was perfected by possession, gave the goods up for a period of time and then took possession back), then its priority time should be the time at which it re-took possession. However, that may not be the case under s 55(5)(b) because that was not the time at which its security interest was "first" perfected. The alternative drafting suggested above circumvents this problem.

**Proposed recommendation 2.68:** That s 55(5) be amended as described above.

6.4 Section 57 – perfection by control

6.4.1 Should perfection by control enjoy a superior priority?

I have already raised for discussion the question of whether the Act should allow certain security interests to be perfected by control – see Section 4.3 above. The following discussion assumes that the concept of perfection by control is retained.

Section 57(1) provides that:

(1) A security interest in collateral that is currently perfected by control has priority over a security interest in the same collateral that is currently perfected by another means.

A similar provision can be found in the Canadian PPSAs, but not in the NZ PPSA.

The rule in s 57(1) applies for all types of collateral for which perfection by control is permitted.

Even if it is accepted that security interests over certain types of collateral should be able to be perfected by control, it does not necessarily follow that a security interest, if perfected in this way, should rank ahead of security interests that are perfected by other means.

**Intermediated securities**

The genesis for the super priority that the Act affords to security interests that are perfected by control appears to be one or more of the UNIDROIT Securities Convention, Article 9 and the Canadian PPSAs. As discussed in Section 4.3.2, though, it must be asked whether it is premature for the Act to be providing for perfection by control over intermediated securities, or for affording a superior priority position for security interests that are perfected in that way.

**ADI accounts**

It could be argued that allowing an ADI to perfect by control over its own ADI accounts is consistent with the fact that ADIs are also able to rely on set-off rights, and on their general law right to combine accounts. The superior priority position that an ADI is able to achieve through perfection by control could simply be seen to be a confirmation of the position that ADI is expected to enjoy in any event.

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123 Eg, Sask PPSA, s 35.1(2).
124 See s 21(2)(c) of the Act, and Section 4.3 above.
125 UNIDROIT Securities Convention, Article 19.
Other types of collateral

It is more difficult to understand why a superior priority position should be afforded to security interests that are perfected by control over the other types of collateral listed in s 21(2)(c). I have suggested in Section 4.3 above that some of those types of collateral be removed from the list in s 21(2)(c) – that is, that a security interest should not be able to be perfected by control over some of those types of collateral. Even if perfection by control remains an option for those types of collateral, however, it is not easy to understand why those security interests should have superior priority. As discussed in Section 4.3, perfection by control is the functional equivalent for intangibles of perfection by possession, and it must be asked why perfection by control should enjoy a superior priority, when perfection by possession does not.

I would be interested to hear the views of others on this.

**Proposed recommendation 2.69:** None at this stage, pending further consideration.

6.4.2 **Section 57(2) – priority as between security interests that are both perfected by control**

I have queried earlier whether it is appropriate to permit more than one security interest to be perfected by control over an item of collateral at the same time. See Sections 4.3.2.3 and 4.3.3.2.

If the Act is amended so that only one security interest at a time can be perfected by control over an item of collateral, then s 57(2) can be deleted. If the Act continues to allow more than one security interest at a time to be perfected by control, then s 57(2) should be amended to address the issue discussed above in Section 6.2 in relation to s 55(2), as s 57(2) also appears to leave unanswered the question of which security interest takes priority in the case of collateral that the grantor acquires after both secured parties have put their control mechanisms in place.

**Proposed recommendation 2.70:** That s 57(2) be deleted if the Act is amended so that only one security interest at a time can be perfected by control over the same item of collateral, or otherwise that it be amended to provide, if more than one security interest is perfected by control over an item of collateral at the same time, that priority is afforded to the security interest for which the control mechanisms are put in place first.

6.4.3 **Section 57(2A) – proceeds of collateral under a security interest that is perfected by control**

Section 57(2A) provides as follows:

(2A) A perfected security interest (the **priority interest**) in the proceeds of original collateral has priority over any other security interest in the proceeds, except a security interest in the proceeds as original collateral that is perfected by control, if:

(a) the security interest in the first-mentioned original collateral was perfected by control when the collateral gave rise to proceeds; and

(b) the priority interest is not perfected by control.

This provision is unique to the Act.

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126 See Sections 4.3.6 to 4.3.8.
The drafting of s 57(2A) is not easy to follow. It appears to be saying, broadly, that if a security interest is perfected over collateral by control and that collateral gives rise to proceeds over which the security interest is also perfected (but not by control), then the security interest in the proceeds has priority over any other security interest, unless the other security interest is itself perfected by control.127

This seems to be a very generous concession, and the policy behind it is not clear. In the case of an ADI that has a security interest over an ADI account with it, for example, the effect of the section seems to be that the ADI would have a super-superior priority claim to any property that was acquired using funds from the ADI account. It is hard to understand why this should be so.

I would be interested to hear of reasons why it is desirable to afford this level of additional protection to a security interest that is perfected by control. Unless there is some compelling justification for retaining it, my current view is that it should be deleted.

**Proposed recommendation 2.71:** None at this stage, pending further consideration.

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### 6.5 Section 58 – priority of advances

Section 58 contains this rule:

A security interest provided for by a security agreement has the same priority in respect of all advances (including future advances), and the performance of all obligations, secured by the agreement.

Similar provisions can be found in the Canadian PPSAs128 and the NZ PPSA.129

The intent behind s 58 appears to be that a security interest has the same priority for all amounts and obligations secured by it, whether they arise before or after the security interest itself arises. It is not clear however why the section does not just say this. The current wording also casts doubt (by negative implication) over whether the security interest can cover future obligations. This is undesirable.

In my view it would simplify and clarify the Act if s 58 were amended to reflect this.

**Proposed recommendation 2.72:** That s 58 be amended to read along these lines:

“A security interest has the same priority for all amounts and obligations secured by it, whether they are incurred or arise before or after the security interest arises.”

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### 6.6 Section 59 – circular priority systems

Section 59 provides:

A security interest (the **first security interest**) has priority over another security interest (the **last security interest**) if, by the operation of this Act (including this section):

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127 As a demonstration of the fact that the drafting is not easy to follow, one commentary reads it as having the opposite effect. See Duggan & Brown, para 11.48.

128 Eg Sask PPSA, s 35(5).

129 NZ PPSA, s 72.
(a) the first security interest has priority over security interests of a particular kind (the *intermediate security interests*); and

(b) the intermediate security interests have priority over the last security interest.

Section 59 is unique to the Act. None of the Canadian PPSAs or the NZ PPSA contains a corresponding provision.

Section 59 appears to be designed to deal with circular priority systems. A circular priority system can arise where more than two secured parties have a security interest over an item of collateral, but the effect of the individual priority rules as between each pair of security interests is that none of the secured parties has priority over all the others.

There are a number of ways in which this could arise under the Act. Take, for example, the following fact pattern:\textsuperscript{130}

SP1 has a perfected security interest over G's truck. G purchases a container crane and attaches it to the truck. SP2 then agrees to make G a loan, secured against the crane. SP1 consents to SP2's security interest. SP2 fails to perfect its security interest.

G then grants security over the truck (including the crane) to SP3. SP3 perfects.

This produces a circular priority system:

- SP1 ranks ahead of SP3 (under s 55(4)), and
- SP3 ranks ahead of SP2 (under s 91(b)), but
- SP2 ranks ahead of SP1 (under s 91(a)(i)).

Circular priority systems can arise under section 64, if the accounts financier gives its s 64 notice to some but not all of the prior secured parties. A circular priority system can also arise in a competition that involves the priority rule in s 73. Again, this can be illustrated with an example:

SP1 and SP2 both have perfected security interests over G's truck. SP1's security interest has the earlier priority time.

G takes the truck to T for repairs. T repairs the truck, but refuses to return it to G until G has paid T for the repairs. T happens to know of SP2's security interest, and that is a breach of SP2's security agreement for T to have an interest in the truck. T is not aware of the existence of SP1's security interest.

This produces a circular outcome because:

- SP1 ranks ahead of SP2 (under s 55(4)), and
- SP2 ranks ahead of T (because T cannot satisfy s 73(1)(e)), but
- T ranks ahead of SP1 (under s 73(1)).

Although s 59 appears to be targeted at resolving circular priority systems, it is unable to do so. That is because it does not provide a mechanism for deciding which of the security interests should be the "first security interest" for the purposes of the section.

\textsuperscript{130} The fact patterns in this Section are taken from B Whittaker, *Circular priority conundrums – cutting the Gordian Knot* (2014) 42 ABLR 62.
There is no easy solution for circular priority conundrums. In my view, the best approach is to simply rely on the default priority rules in s 55 where they can apply. In the case of an interest under s 73, of course, s 55 cannot assist because that interest is not a security interest. In that case, the s 73 interest should probably prevail. Either way, s 59 is not the answer. I think it should be deleted.

**Proposed recommendation 2.73:** That s 59 be deleted.

### 6.7 Section 61 – priority agreements

Section 61 provides:

1. A secured party may (in a security agreement or otherwise) subordinate the secured party's security interest in collateral to any other interest in the collateral.

2. The subordination:
   
   a. is effective according to its terms between the parties; and
   
   b. may be enforced by a third party if the third party is the person, or one of a class of persons, for whose benefit the subordination is intended.

Section 61 is based on a corresponding provision in the Canadian PPSA and the NZ PPSA. This has had the result, however, that it has adopted language that is not consistent with Australian terminology. When s 61 refers to a "subordination", it appears to be referring to what we would more usually call a "priority agreement". In Australian parlance, a priority agreement is an arrangement under which one secured party agrees that its prior-ranking security interest is to rank behind another security interest over the same property. A subordination agreement, in contrast, is an agreement under which two creditors agree that the debts owed to one of them should only be repaid if debts owing to the other creditor have been paid first. Those debts could be secured or unsecured.

While it is possible to work out that s 61 is referring to priority agreements even though it speaks of "subordination", the Act will be simpler to follow if it uses familiar language in familiar ways, not in unfamiliar ones.

**Proposed recommendation 2.74:** That the language of s 61 and other relevant sections in the Act be amended to refer to "priority agreements", rather than "subordination".

### 6.8 Sections 62 and 63 – purchase money security interests

#### 6.8.1 The scope of the term

1. **Leases that are in-substance security interests**

   The term "purchase money security interest" is defined in s 14(1):

   
   1. A *purchase money security interest* means any of the following:
      
      a. a security interest taken in collateral, to the extent that it secures all or part of its purchase price;

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131  Eg Sask PPSA, s 40(1).

132  NZ PPSA, s 70.
(b) a security interest taken in collateral by a person who gives value for the purpose of enabling the grantor to acquire rights in the collateral, to the extent that the value is applied to acquire those rights;

(b) the interest of a lessor or bailor of goods under a PPS lease;

(d) the interest of a consignor who delivers goods to a consignee under a commercial consignment.

The Canadian PPSAs\textsuperscript{133} and the NZ PSA\textsuperscript{134} contain a similar definition.

It can be seen that the definition captures leases that are security interests if they are PPS leases. However, it is not so clear how the definition captures a lease that is an in-substance security interest under s 12(1), but not a PPS lease as well (for example, because the lease is for a term of less than one year, or because the lessor is not regularly engaged in the business of leasing goods). This may not have been a concern under Article 9 or the Canadian PPSAs (from which the definition originates), on the basis that security leases were recharacterised by US and Canadian law as secured loans, and so covered by paragraph (a) of the definition. That is not the case, however, under Australian general law. There is no obvious reason why the concept of a PMSI should cover a lease that is a PPS lease, but not cover a lease that is an in-substance security interest without being a PPS lease as well.

The intention may have been that leases are in-substance security interests are covered by paragraph (a) and (b), but that places undesirable strain on the language of those paragraphs. It would help the Act if this were clarified.

**Proposed recommendation 2.75:** That s 14(1) be amended to make it clear that it captures all leases that are security interests, whether or not they are a PPS lease.

### 6.8.1.2 Sale and lease-backs

Section 14(2)(a) states that an interest will not be a PMSI, even if it is otherwise within s 14(1), if the interest is:

(a) an interest acquired under a transaction of sale and leaseback to the seller; ...

There is a similar qualification in the Canadian PPSAs\textsuperscript{135} and the NZ PSA.\textsuperscript{136}

One of the reasons given for allowing a PMSI to take priority over prior-perfected security interests is that a PMSI swells the grantor's asset pool, by adding a new asset to it. As the PMSI does not reduce the asset base over which a prior-perfected security interest has priority, the prior secured party should be indifferent to the fact that the PMSI holder has priority over the new asset.

This explains why sale and lease-backs are excluded. Under a sale and lease-back, no new asset is being added to the grantor's asset pool. Rather, an existing asset is being taken out of the pool and then returned to it.

\textsuperscript{133} Eg Sask PSA, s 2(1)(jj).

\textsuperscript{134} NZ PSA, s 16(1).

\textsuperscript{135} Eg Sask PSA, s 2(1)(jj).

\textsuperscript{136} NZ PSA, s 16(1) (definition “Purchase money security interest”, para (b)).
One submission suggested that not all sale and lease-backs should be excluded, and that a sale and lease-back should be able to qualify for PMSI treatment if the asset is "almost new", in that it was acquired by the grantor in anticipation of the sale and lease-back, and simply held by the grantor for a short period of time to enable the sale and lease-back to be completed.

There could be good commercial reasons why a grantor needs to complete the initial acquisition of an asset itself, rather than arrange for title to pass direct to a PMSI financier. The grantor may have standing purchase arrangements in place with a long-term supplier that do not allow it to require that title to a particular asset go direct to the PMSI financier. It is also possible, if the goods come from overseas, that the PMSI financier will want the grantor to complete the import process itself, before title then passes to the PMSI financier. The potential downside to allowing a window of time within which a grantor can own an asset before passing it on to a PMSI financier, though, is that the grantor may need to fund the purchase price from other sources in the meantime, and might do this by way of a further loan from a prior-registered secured party. That loan may not then be repaid from the proceeds of the later PMSI funding.

Allowing sale and lease-backs on this basis could inappropriately disadvantage prior secured parties, for this reason. As an alternative solution, it might be possible to allow a sale and lease-back to be a PMSI if the grantor has title for only a short period of time and the PMSI financier pays its purchase price for the goods direct to the person who sold the goods to the grantor. That may not always be practicable, but would allow some flexibility.

The same submission also suggested that a sale and lease-back transaction involving a used motor vehicle should be able to qualify as a PMSI if the grantor is a motor vehicle dealer that holds the vehicle as inventory, and wants to finance the vehicle using a bailment or floor plan financing arrangement. This was said to be relevant when the vehicle was a trade-in, presumably because the dealer has no option but to acquire the vehicle directly in such a situation.

I can understand the practical difficulties that this presents for motor vehicle dealers. This proposal faces the same difficulty as just discussed, though, which is that the used vehicle does not add new value to the dealer’s asset base. It is acquired in part-exchange for another asset (the new vehicle purchased by the customer), and while that vehicle may itself have been financed by a PMSI, that will not necessarily be the case.

My view is that the benefits of this proposal are likely to be outweighed by the difficulties involved in drafting it in a way that did not adversely affect other secured parties, and by the complexity that this would add to the Act. As discussed elsewhere, I am also not generally in favour of addressing issues through ad hoc carve-outs unless there is a truly pressing need to do so.

I would be interested to hear further views on the matters raised in this Section.

**Proposed recommendation 2.76:** None at this stage, pending further consideration.

### 6.8.1.3 Personal, domestic or household goods

Sections 14(2)(c) and 14(2A) have the effect that a security interest in an asset cannot be a PMSI if the grantor intends to use asset predominantly for personal, domestic or household purposes, unless the asset is serial-numbered property.
These provisions are unique to the Act.

It is difficult to see what the policy rationale might be for this. The "new value" rationale for the PMSI priority should not be any less applicable just because the collateral is to be used for personal, domestic or household purposes, and much of the effect of the carve-out is eroded in any event by the qualification for serial-numbered property (which would exclude motor vehicles from the carve-out). I would be interested to hear if there is a more cogent explanation for the carve-out. If there is not, then my view is that ss 14(2)(c) and (2A) should be deleted.

Proposed recommendation 2.77: That ss 14(2)(c) and (2A) be deleted.

6.8.1.4 Should PMSIs be able to be cross-collateralised?

The definition of "PMSI" in s 14 provides that a security interest in collateral will only be a PMSI to the extent that it secures (broadly) the unpaid purchase price of the collateral.\textsuperscript{137} For example, if a supplier's retention of title clause states that the supplier retains title to goods until it has been paid both the purchase price for those goods and all other amounts owed (eg on account of other supplied goods), then the security interest over those goods will only be a PMSI to the extent of the unpaid amount of those goods, and a non-PMSI security interest for the balance.

If a supplier has made a number of deliveries to a customer, and a competing secured creditor enforces its security over the customer at the time when the supplier has been paid for some but not all of them, the supplier may only be able to successfully assert its PMSI priority if it is able to demonstrate which deliveries have been paid for, and which not. If two or more deliveries are of identical products, the supplier may need to show which of the goods relate to which delivery. This may be impossible to do.

Article 9 responds to this dilemma by allowing the PMSIs in this situation to cross-collateralize, if the collateral is inventory.\textsuperscript{138} This means that the supplier can claim PMSI status for its security interest over all the goods it has supplied that are still held by the buyer, without needing to demonstrate which of the particular deliveries remains unpaid.

One of the submissions recommended that this approach be adopted in the Act. I can see merit in that suggestion, and would be interested to hear whether others agree.

Proposed recommendation 2.78: None at this stage, pending further consideration.

6.8.1.5 Use of the term "PMSI" in the Act

One submission noted that the Act refers in many places to a PMSI, without it necessarily being clear whether it is intended to refer to any security interest that is within the definition of the term in s 14, or whether is only intended to refer to a PMSI that has qualified for the PMSI priority in s 62. The submission suggested that it might be helpful to clarify which meaning is intended in each section.

The current approach is consistent with the approach taken in the Canadian PPSAs and the NZ PSA. The suggestion is however worthy of consideration. I would be interested to hear the views of others on this.

\textsuperscript{137} See ss 14(7) and (8).
\textsuperscript{138} Article 9, §9-103(b)(2).
Proposed recommendation 2.79: None at this stage, pending further consideration.

6.8.1.6 Refinancing a PMSI

Section 14(5) provides as follows:

(5) A purchase money security interest does not lose its status as such only because the purchase money obligation is renewed, refinanced, consolidated or restructured (whether or not by the same secured party).

There does not appear to be a corresponding provision in the Canadian PPSAs or the NZ PPSA. Canadian courts have however gone some way towards implying the same result into their legislation.139

The section has the effect, for example, that a security interest that was taken to secure a loan that funded the purchase of an asset will not cease to be a PMSI just because the loan is refinanced or restructured, as long as it remains secured by that security interest.

The section does not say what happens, however, if the security interest itself changes – for example, if a manufacturer sells some goods on retention of title terms, and later agrees to transfer title to the grantor in return for taking a security interest (in the more traditional way) for its unpaid purchase price.

This question arises frequently in the equipment finance sector, particularly if a grantor wants to refinance a PMSI financing with a different financier. If the initial PMSI finance was by way of a secured loan, it would be possible in theory for the outgoing financier to transfer the secured loan (with the security interest) to the new financier. That, however, would be an administratively inefficient way to approach the refinance, and would not be consistent with market practice. And even that approach will not work if the new financier uses a different type of PMSI – for example, if the outgoing financier had provided a secured loan, but the incoming financier wants to provide its PMSI finance by way of a lease.

Some submissions suggested that the "rollover" protection in s 14(5) should also allow the security interest itself to be replaced. It is argued that this would not adversely affect other secured parties, and would enhance the grantor's ability to access cost-effective finance by expanding its capacity to utilise available financing sources.

I am of the view that this could be a valuable enhancement, and would further assist the Act to achieve one of its key objectives. Further thought would need to be given, however, to the extent to which the incoming financier should repeat any notice procedures that might be required for PMSI priority. See Section 6.7.3 below.

Proposed recommendation 2.80: That s 14(5) be expanded to make it clear that a security interest that replaces a PMSI can also be a PMSI, and can inherit the replaced PMSI's priority status.

139 See Cuming Walsh & Wood, pages 456 to 460.
6.8.2 The timeframe for registration

6.8.2.1 When should the time period start?

Section 62 provides that a PMSI that is perfected by registration within the time frame required in the section will have a preferred priority position, in that it can defeat a security interest that is not a PMSI even if the non-PMSI security interest has an earlier priority time. If the collateral is goods and is inventory, the security interest needs to be perfected by registration before the grantor "obtains possession". If the collateral is goods but not inventory, the secured party needs to perfect by registration within 15 business days of the grantor obtaining possession.140

The Canadian PPSAs141 and the NZ PPSA142 contain similar provisions.

A number of submissions suggested that the time period within which the secured party needs to perfect by registration in relation to goods should be calculated from the time at which the secured party agreed to fund the PMSI, rather than from when the grantor obtained possession. The submissions said that the current approach is of particular concern for the motor vehicle finance industry, because it does not reflect Australian market practice.

The current structure of s 62 is a reflection of the way in which the motor vehicle finance industry apparently operates in North America. In North America, the finance typically is initially provided by the motor vehicle dealer, and the dealer makes any necessary registrations. The dealer then bundles up its finance contracts at appropriate intervals and transfers them to a financier (as chattel paper – see Section 4.2.2 of Consultation Paper No. 1). The dealer will be able to ensure that the PMSI registrations are made on time, because the dealer will know when the grantor is given possession of the vehicle.

In Australia, the motor vehicle finance industry is structured quite differently. Here, the dealer does not provide the finance itself. The dealer may assist the purchaser/grantor to fill in the finance company's paperwork, but it will simply send the paperwork off to the finance company, potentially at irregular intervals. If the finance company approves the finance, it will then reimburse the dealer for the agreed amount, and itself make the necessary registrations at that time.

The finance company will not necessarily know, however, exactly when the dealer gave possession of the vehicle to the grantor. And there is a risk that more than 15 business days could pass before the finance company receives the paperwork from the dealer and completes the registration. As a way to address this, some submissions argued that the time period should be calculated by reference to the point in time at which the finance company approves the finance. As a trade-off, it was also suggested that the time period could then be shortened.

This would clearly assist the motor vehicle finance industry. The proposal does however raise some concerns. Even if the time period is shortened, the proposal has the potential to significantly lengthen the aggregate period of time within which the PMSI may be perfected by registration. It also makes it extremely difficult for another secured creditor to determine whether the registration was in fact made within the

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140 The same time periods apply for collateral other than goods as well. In that case, though, they are determined by reference to the point in time at which the security interest attaches to the collateral.

141 Eg Sask PPSA, ss 34(2) and (3).

142 NZ PPSA, ss 73 to 75.
necessary time frame, because that other secured party will have no way of being able to ascertain when that time period commenced.

I am not currently convinced that the open-ended nature of this proposal is justified. Having said that, the issue may go away as the result of the discussion in Section 6.8.3 below. In that case, there would be less point in tying the PMSI financier to a specific registration timeframe.

I do however understand the frustrations of the motor vehicle finance industry, and believe that it is worthwhile continuing to explore solutions. I would also be interested to hear the views of others on this.

**Proposed recommendation 2.81:** None at this stage, pending further consideration.

### 6.8.2.2 Capacity in which the grantor has possession

Section 62 does not clearly explain how the registration timeframes are to be determined if the grantor has possession of the collateral in some other capacity before the goods become subject to a PMSI. This could happen, for example, if a farmer takes possession of some machinery for testing purposes before then agreeing to buy it (and finance it under a secured loan or lease). The question could also arise if a lessee has leased goods for an indefinite term, and the lease runs for more than one year so that it becomes a PPS lease (if my proposed recommendation 1.17 in Section 4.4.5 of Consultation Paper No. 1 is adopted).¹⁴³

In my view, the answer is that the timeframe is to be determined by reference to the time at which the grantor possesses the goods **in its capacity as grantor** – while it will have had possession before then, this will have been in a different capacity and should not count. One of the submissions suggested that this be confirmed, and I agree. Rather than amend the Act, though, I would prefer to rely on the fact that a statement along these lines, if included in my final report, may be extrinsic material of a type referred to in s 15AB(2)(b) of the Acts Interpretation Act 1901, and so available to assist in the interpretation of the Act.

### 6.8.2.3 How long should the time period be?

Some submissions suggested that the timeframes for PMSI registrations should be aligned with other relevant timeframes, such as the 20 business day period under s 588FL of the Corporations Act.

Section 588FL will be considered in a later paper. For present purposes though, I do not see a compelling need to align the PMSI timeframes with that section.

Another submission suggested that the registration period for PMSIs over inventory could be extended. The Act currently requires that a PMSI over inventory be perfected by registration before the grantor obtains possession of the goods, if it is to benefit from the PMSI priority. This is in contrast to the position for non-inventory, for which the secured party has 15 business days to register.

This distinction in procedural requirements derives from the Canadian PPSAs.¹⁴⁴ Under those Acts, however, the PMSI financier also needs to send a notice to prior-registered secured parties, to alert them to the fact that it will be taking a PMSI over the grantor's

¹⁴³ This assumes that the lease is not an in-substance security interest.

¹⁴⁴ Eg Sask PPSA, s 34.
inventory. The PMSI financier must send them the notice before the grantor obtains possession of the inventory, so that the prior secured party is warned in advance that it will not have priority over the new inventory and so has an opportunity to decide whether or not to advance further funds against it. The requirement that the PMSI financier also register before the grantor obtains possession is related to this.

Currently, s 62 does not require the PMSI financier to send notices to prior secured parties. That is discussed in the next Section. If the Act is not amended to require the PMSI financier to notify prior secured parties that it is taking a PMSI, then there may well be merit in simplifying s 62 to provide a 15 business day registration timeframe for all types of PMSI.

Proposed recommendation 2.82: None at this stage, pending further consideration.

6.8.3 Should the registration need to indicate that the security interest is a PMSI? Should a PMSI financier be required take other steps to notify prior secured parties of its PMSI?

Section 62(2)(c) states that a PMSI will only be eligible for the preferred priority status under s 62 if the registration indicates that it is a PMSI. This is often referred to colloquially as "ticking the PMSI box".

Should s 62(2)(c) be deleted?

A number of submissions suggested that s 62(2)(c) should be deleted. They argued that many registrants do not know how to decide whether to tick the PMSI box, and that the consequences of answering the question incorrectly are too draconian – the secured party could lose its PMSI priority (if it has a PMSI but fails to indicate that correctly in the registration), or its registration could be entirely ineffective under s 165(c) (if it claims PMSI status for a security interest that is in fact not a PMSI).

The Canadian PPSAs145 and Article 9146 do not require the financing statement to disclose that the security interest is a PMSI. Instead, if the collateral is inventory they require the secured party to notify prior-registered secured parties of its PMSI. This is clearly more helpful for secured parties with a prior registration than the Australian approach, as the Australian approach will only alert existing secured parties to the existence of the PMSI if they happen to do a check search.

The position in New Zealand is different again. New Zealand does not require that notice be given to existing secured parties, or that the registration indicate that the security interest is a PMSI. It has been said that the reason for this was that:147

the PMSI super-priority rule merely reflects the rights that title-holders (such as suppliers retaining title under a "romalpa clause") would otherwise have had under the previous law, and that general financiers tended, in any case, to discount the value of inventory under their all assets security.

Which approach is best? The North American approach is the most favourable to existing secured parties, as they receive notice of the PMSI and do not need to rely on

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145 Eg Sask PPSA, s 34(3).
146 Article 9, § 9-324(b).
check searches. The Australian approach, in contrast, only helps existing secured parties if they do in fact undertake check searches (for example, before advancing further funds). This would not be customary, and would be likely to impose a significant administrative burden on bank lending departments. The New Zealand approach is the least helpful of all to existing secured parties, as it provides no mechanism that could alert them to the existence of later PMSIs, whether by way of a check search or otherwise.

It seems to me that the current approach in the Act relies on an assumption that is not necessarily valid, which is that secured parties routinely undertake check searches before advancing further funds. If that assumption is indeed incorrect, then it may be fair to argue that the Act should not require a secured party who takes a PMSI to indicate this in the registration (as nothing is gained from it), and that s 62(2)(c) should be deleted.

If s 62(2)(c) is retained, should the PMSI holder be required to provide more information?

One submission pointed out that a PMSI does not automatically benefit from the PMSI priority just because it is perfected by a registration that has ticked the PMSI box. As noted in Section 6.8.2.1, a PMSI over goods will only benefit from the PMSI priority if the registration was made within time – before the grantor obtained possession if the goods are inventory, or within 15 business days of that time if they are not.

A searcher of the Register will not be able to tell whether a PMSI registration was made within the required timeframe, and so will not be able to tell whether a PMSI does in fact have PMSI priority. The submission suggested for this reason, if s 62(2)(c) is retained, that the PMSI holder should also be required to set out in the registration the date on which the grantor obtained possession (if this is known), or alternatively to indicate in the registration that the grantor will obtain possession after the registration has been made.

I can see that this could potentially provide a searcher with information that would help it to determine whether a particular PMSI did have the benefit of the PMSI priority, at least in circumstances involving non-inventory where the registration is not made until after the grantor has taken possession of the goods. It is likely, however, that this proposal could produce significant practical difficulties for a secured party, and I anticipate that the incremental benefit that this suggestion might produce would be outweighed by its detriments.

If s 62(2)(c) is deleted, should the PMSI holder be required to give notice instead?

If s 62(2)(c) is deleted, what if anything should be included in its place? Should the Act adopt the North American approach of requiring the PMSI holder to notify existing secured parties, or the New Zealand approach, and not require the PMSI holder to take any additional steps at all? A PMSI holder would no doubt argue that it should not be put to the effort of having to notify prior-registered secured parties that it is taking a PMSI. It does however appear to be the established practice in North America. It might also be possible for secured parties to automate the process, particularly if the functionalities of the Register could be enhanced so as to allow Register users to download email addresses direct from the Register.

I would be interested to hear further views on these issues, before I formulate a recommendation.

**Proposed recommendation 2.83:** None at this stage, pending further consideration.
Section 64 - accounts financiers

The priority rule, and the policy behind it

Section 64 provides that a non-PMSI that is taken for new value in an account as original collateral, and is perfected by registration, can have priority over a perfected PMSI that is granted by the same grantor in the account as proceeds of inventory. The non-PMSI in the account will rank ahead of the PMSI if it is perfected by registration before the registration time for the PMSI. It will also rank ahead of earlier PMSIs, if the secured party gives a prescribed notice to the holders of those PMSIs in accordance with the section.

A number of the Canadian PPSAs also include a provision that allows a security interest in an account as original collateral, if given for new value and perfected by registration, to rank ahead of later PMSIs. The NZ PPSA does this too. In other words, they disengage the priority that the later PMSI would otherwise have because of its PMSI status, and allow priority to be determined by the “first to perfect” principle. Australia is unique, however, in allowing the non-PMSI to defeat PMSIs with an earlier priority time as well.

Section 64 is designed to assist companies to finance their working capital through the sale or other financing of their accounts through an accounts financier. The explanation given overseas for this rule is that an accounts financier would not be prepared to purchase or lend against a company’s accounts if they constantly faced the risk of losing priority to subsequent PMSI holders. By disengaging the PMSI priority for later PMSI holders, the accounts financier can rely on its registration, and the state of the register at the time that it registered, to determine its priority position. It is said that this does not overly compromise the position of subsequent PMSI holders, as they can search the register before taking their PMSI to see if an accounts financier has registered against the grantor, and so determine what the strength of their PMSI will be over any accounts that the grantor generates through the sale of their inventory.

That analysis assumes that it is apparent from the accounts financier’s financing statement that it has or will have a security interest over the grantor’s accounts. I will return to that point shortly. In the present context, though, the point to note is that this analysis does not explain why it is appropriate to enable the accounts financier to defeat prior PMSI holders as well.

I am advised that this additional concession was granted because of the importance of the receivables finance industry to Australian businesses. The Canadian PPSAs and Article 9 afford special protections to chattel paper, including a capacity to defeat prior security interests, because of the important role that chattel paper plays in North American financing practice. Enabling an invoice financier to defeat prior PMSIs is said to be based on the same principle, applied in the Australian context.

This argument sounds well-made. One submission did however question the rationale for the s 64 priority regime. The issue was not raised in other submissions, but I am unable to tell whether this is because there is no concern with the overall policy intent of the section, or whether it is because the industries that supply inventory on retention

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148 And before the PMSI is perfected in some other way.
149 Technically, this should be a PMSI that has already been perfected, or that has an earlier registration time. The terms “earlier”, “later” and similar expressions are used here to simplify the explanation.
150 Eg Sask PPSA, s 34(6).
151 NZ PPSA, s 75A.
of title terms do not have an organisation that speaks for them on questions such as this. Unless I receive representations to the contrary, I will assume that the policy position in s 64 has broad acceptance, and not consider whether there is a need for change.

6.9.2 The "new value" requirement

The argument in favour of allowing an accounts financier to defeat the holder of an earlier PMSI relies in part on the fact that the accounts financier only has priority if it provides "new value" for the account. This has been said to have the result that the PMSI holder is not disadvantaged by the s 64 priority, because it can trace its PMSI into that new value and rely on it as its source of payment instead.

That argument assumes, however, that the "new value" has substance. As noted in Section 5.4.1.2.3 above, that is not necessarily the case. That Section invites comments on whether this is appropriate.

6.9.3 What earlier security interests should the accounts financier be able to take priority over?

6.9.3.1 Non-PMSI security interests?

Section 64 allows an accounts financier to take priority over earlier PMSIs, but not over other earlier security interests. If an earlier financier had a general security interest rather than a PMSI, then s 64 will not help the accounts financier, and they would need to negotiate a priority agreement with the earlier financier in order to take priority.

The value of s 64 is further eroded by the fact that the main type of PMSI financier, a supplier of inventory who sells goods on retention of title terms, will often use an "all-moneys" retention of title clause. Under s 14(3), that clause will give rise to a PMSI over the supplied goods in relation to the purchase price of those particular goods, and will be a security interest (but not a PMSI) in relation to all other secured amounts. Some suppliers also take an express security interest over sale proceeds as original collateral, and make a separate registration against the collateral class "accounts". Both these processes reduce the extent to which an accounts financier can benefit from s 64.

If the full benefit of s 64 is to be realised, it might be appropriate to allow the accounts financier to take priority over all security interests held by the PMSI financier over the account, not just the PMSI over the account as proceeds of the inventory over which the financier held the PMSI as original collateral. I would be interested to hear the views of others on this.

Proposed recommendation 2.84: None at this stage, pending further consideration.

6.9.3.2 PMSIs granted by a different grantor?

One submission also queried whether it is appropriate that the operation of the section be limited to PMSIs that are granted "by the same grantor". The submission suggested that this can be unduly limiting in transactions involving a chain of leases and subleases, where the accounts financier wants to purchase payment rights under the bottom sublease. Section 64 may be unhelpful in such a transaction because the PMSI that the accounts financier is competing with may have been granted by a grantor higher up the leasing chain.
It is not clear how often this would arise in practice. The issue may also be resolved by
the approach that is ultimately taken to the treatment of leases and subleases, as
discussed in Section 5.2. I would however be interested to hear views on the
importance (or otherwise) of the fact that s 64 currently applies only to PMSIs that are
granted by the same grantor.

6.9.3.3 PMSIs perfected other than by registration?

Section 64(1)(a) provides that an accounts financier will only defeat PMSIs by means of
its registration (rather than by giving notices under s 64(1)(b)) if it registers before the
earlier of the registration time for the competing PMSI, or the time at which the
competing PMSI is perfected.

The effect of this second option (the time at which the competing PMSI is perfected) is a
little unclear. It would be expected that all (or nearly all) PMSIs would be perfected by
registration, and the only potential role for this additional language may be to pick up
situations where a PMSI is perfected by possession, or by one of the temporary
perfection rules. It is not clear how often that would happen.

The presence of the second option in s 64(1)(a) also presents potential difficulties for an
accounts financier. If a PMSI is perfected by a means other than registration, the
accounts financier is unlikely to be able to find out about it. This means as a practical
matter that the accounts financier cannot rely on the alternative mechanism (the notice
mechanism in s 64(1)(b)) to take priority, as they will not know where to send the
notice (indeed, they will not even know that they need to send the notice).

This is not particularly practical. It might be thought appropriate for these reasons to
amend s 64(1)(a) so that it only refers to PMSIs that have an earlier registration time. I
would however be interested to hear the views of others on this.

6.9.4 The nature of the registration

As just discussed, the policy balance as between an accounts financier and subsequent
PMSIs is currently tipped in favour of the accounts financier because the holder of the
subsequent PMSI can search the Register before agreeing to finance the grantor's
inventory. That assumes, however, that it will be apparent from the Register that the
accounts financier is taking a security interest over the grantor's accounts.

Under the current rules for registering financing statements, an accounts financier is not
required to register against the collateral class "accounts". Rather, it could register
against the collateral class "all present and after-acquired property", or "all present and
after-acquired property, except". This flexibility will be discussed more generally in a
later consultation paper. For present purposes, however, it should be asked whether an
accounts financier should only be able to rely on s 64 if it registers a financing
statement against the collateral class "accounts". This would at least help later PMSI
holders to narrow down their field of enquiry when they do their search.

This would not prevent an accounts financier from making a wider registration as well, if
that was needed. However, it would help later PMSI holders without greatly
inconveniencing the accounts financier.

**Proposed recommendation 2.85**: That s 64 be amended to require that the
relevant registration be against the collateral class "accounts".
6.9.5 **The notice process**

Section 64 provides that an accounts financier can take priority over an earlier PMSI by giving the secured party notice at least 15 business days before the earlier of the day on which the accounts financier registers its financing statement, and the day on which the account financier’s security interest attaches.

A number of submissions pointed out that this exposes the accounts financier to the risk that another PMSI holder might register a financing statement within that 15 business day period. If that happens, the accounts financier would need to give notice to that new PMSI holder as well, and then wait a further 15 business days. This is not very efficient. Some accounts financiers have overcome this “rolling 15 business day problem” by using a number of carefully-constructed financing statements, registered in a specific order. Submissions suggested, however, that the problem could be addressed more simply, by providing that the accounts financier can register before or when it gives the notice (rather than wait 15 business days), but on the basis that the s 64 priority will only apply to accounts to which its security interest attaches after the 15 business days have expired.

The intent behind the advance notice is to give an existing PMSI holder an opportunity to respond to the prospect of losing its priority, for example by shortening its credit terms or moving to a cash-on-delivery basis. That opportunity may be more theoretical than real. Whether or not that is the case, the proposed alternative does not appear to operate to the further detriment of an existing PMSI holder, and significantly simplifies the operation of s 64. I think that this is a worthwhile proposal.

One submission suggested that the 15 business day period should be shortened to 5 business days. I believe that this would not give the inventory financier sufficient time to respond, should it want to. I would however be interested to hear the views of others on this.

**Proposed recommendation 2.86:** That s 64(1)(b) be amended to provide that the “priority interest” in an account will take priority over existing perfected purchase money security interests, and purchase money security interests that have an earlier registration time (if that language is retained), if the priority interest is perfected, and the non-PMSI financier’s security interest first attaches to the account at least 15 business days after it gives notice to the secured party in accordance with s 64(2).

6.9.6 **To whom should the notices be given?**

One submission suggested that s 64(1)(b)(i) should only require that the notices be given to the secured parties that indicated in their registration that their security interest is a PMSI. This could work in either of two ways. It might mean that the accounts financier only obtains priority over earlier PMSIs that were registered as such. That would however be a somewhat perverse result, as the accounts financier would rank ahead of earlier PMSIs that did enjoy PMSI priority, but behind earlier PMSIs that did not. The more likely effect of such an approach would be that the holder of a perfected PMSI that did not enjoy PMSI priority would rank behind the accounts financier, but not receive any warning of this because they did not get the notice.

Section 6.8.3 has already discussed whether the PMSI box should be retained. Even if it is retained, my preference is not to limit the notices to secured parties who have claimed PMSI status in their registration. While there is undoubtedly sending out the s 64 notices does involve administrative effort, automation should be able to help to keep the workload to manageable levels, particularly if users of the Register are able to download email addressed directly from the Register, and in fairness to the PMSI
holders who are about to lose their priority, I think it is appropriate that they receive a notice to alert them to this.

6.9.7 **What should the notices say?**

Section 64(2)(b)(i) provides that the notice must contain "a description of the inventory to which the notice relates". One submission suggested that it be made clear that the description can be generic, as it would be a formidable task to require the accounts financier to tailor the notice for each addressee, even if the accounts financier had the information it would need to do this.

The section may already allow the notice to be quite generic, as a "description" of personal property is defined in s 10 to include a description that simply identifies the class to which the personal property belongs. I agree though that an accounts financier should not need to wrestle with this question, and that it should be sufficient for the notice to state that:

- the accounts financier may be acquiring an interest in accounts that are proceeds of inventory in which the PMSI holder may also have a security interest; and
- the effect of s 64 is that the accounts financier will have priority over the PMSI in relation to accounts to which its security interest attaches after 15 business days from the day the notice is given.¹⁵²

**Proposed recommendation 2.87:** That s 64(2)(b) be amended as described above.

6.10 **Sections 73 – interests that arise by law – trustee's liens**

One submission suggested that s 73 be amended to address the priority of a trustee's lien as against a secured party with a security interest in the trust assets.

The juridical nature of a trustee's lien is not clear.¹⁵³ The issue identified by the submission is based however on the fact that the lien (however characterised by the law) can allow a trustee to satisfy (or reimburse itself for) properly incurred debts, out of trust assets. If a trustee of a trust with an ABN grants a security interest both in its own right and as trustee to secure a debt that it properly incurred as trustee, but the secured party only registers a financing statement against the trustee's ACN and not the trust's ABN, then this would suggest that the security interest was unperfected as against the trust assets, and would rank behind other perfected security interests over those assets. However, the security interest is perfected as against the trustee personally, so if the trustee's lien ranks ahead of security interests over the trust assets, could the secured party still defeat perfected security interests over the trust assets "through the back door", because it has security over the trustee's personal assets, including its rights under the lien?

The submission suggested that the appropriate response might be to subordinate the trustee's lien to security interests that are perfected over the trust assets. While that would respond to the immediate issue, it could be problematic on broader grounds.

¹⁵² This assumes that proposed recommendation 2.86 is adopted. See Section 6.9.5.

¹⁵³ See N D'Angelo and H Busljeta, The Trustee's lien or charge over trust assets: A PPSA security interest or not? (2011) 22 JBFLP 251.
It might be that this issue will be resolved by possible changes to the operation of the Register, that will be discussed in a later paper. In the meantime, I would be interested to hear the view of others on this quite difficult question.

**Proposed recommendation 2.88:** None at this stage, pending further consideration.

6.11 **Section 74 – execution creditors**

6.11.1 **Does the section reflect Australian practice?**

Section 74 provides relevantly as follows:

(1) The interest of an execution creditor in collateral has priority over any security interest in the same collateral that is not perfected at the time covered by subsection (4) (even if such a security interest is later perfected).

... 

(4) This subsection covers the following times:

(a) if the collateral is seized by the execution creditor or by another person on behalf of the execution creditor—the time of seizure;

(b) in any other case—the time when:

(i) an order is made by a court in respect of a judgment in relation to the execution creditor; or

(ii) a garnishee order is made in relation to the execution creditor.

Section 74 follows similar provisions in the Canadian PPSAs and the NZ PPSA. It is not clear, however, that s 74(4)(a) accurately reflects the manner in which an execution creditor in Australia is able to arrange for a person’s property to be seized and sold, and for the sale proceeds to be applied to satisfy a judgment debt owed to it by the person. As I understand it, the property under an Australian execution process is not seized by the execution creditor, but by a sheriff. And the sheriff does not seize the property “on behalf of the execution creditor”, but as an officer of the court. If this is correct, then it may be that s 74(4)(a) has no role to play, and could be deleted. This would help to simplify the Act.

**Proposed recommendation 2.89:** That s 74(4)(a) be deleted.

6.11.2 **Application to future property**

As one submission pointed out, another concern with s 74 is the way in which it can apply to future property. A secured party may have taken all-assets security from a grantor, and have appropriately registered an "all present and after-acquired property" financing statement. Its security interest will not be perfected, however, over property that is not yet in existence (or in which the grantor does not yet have sufficient rights to support attachment for some other reason), as the security interest will not yet have attached to that property. If it is possible for a writ of execution to relate to property that a grantor might acquire after the writ is issued, then the execution creditor will necessarily rank ahead of the secured party, even though the secured party had already taken all steps that it could to perfect its security interest. This seems to be an anomaly, and should be addressed.

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154 Eg Sask PPSA, s 20(1).
155 NZ PPSA, s 103.
Proposed recommendation 2.90: That s 74(1) only allow an execution creditor to have priority over a security interest, if the "priority time" for the security interest is after the date specified in the section.

6.11.3 Application to interests that are not security interests

As the same submission pointed out, the combined effect of s 8(2) and reg 1.4(5)(b) of the Regulations is that s 74 applies to some interests that are not otherwise subject to the Act.

It is not clear whether the objective of these provisions is simply to ensure that s 74 can function as intended even though the execution creditor's interest is itself not a security interest, or whether these provisions are saying that the execution creditor's interest can defeat those other types of interests, even though the Act does not otherwise apply to them. If the latter is correct, then the holder of such an other interest is put in an invidious position, as they will be defeated by the execution creditor if their interest is unperfected, yet will be unable to perfect their interest because it is not subject to the Act.

In my view, s 74 should only allow an execution creditor to defeat an interest that is subject to the Act. The Act could usefully be amended, however, to clarify this.

Proposed recommendation 2.91: That s 8(2) and reg 1.4(5)(b) be amended to make it clear that s 74 can only afford an execution creditor priority over another interest if that other interest is subject to the Act.

6.12 Section 76 – security interests with different grantors

Section 37 deals with situations where collateral has been sold or leased in a manner that allows the buyer or lessee to take the collateral free of a security interest, but the collateral comes back into the possession of the seller, lessor or a transferee of chattel paper because the sale or lease has been rescinded or expires, or has been enforced. The section provides, broadly, that the security interest re-attaches to the collateral, and that the security interest is taken to have been continuously perfected over the intervening period, if it was perfected by registration and the registration is still current. Section 38 deals with a similar situation, but in circumstances where the sale or lease created an account or chattel paper and the seller or lessor has transferred the account or chattel paper to another person. If the collateral is returned because the sale or lease has been rescinded or expires or has been enforced, then s 38 deems the transferee of the account or chattel paper to have a security interest in the collateral (as compensation for the fact that the account or chattel paper will have been rendered largely worthless by the return of the collateral). In this case, the deemed security interest is temporarily perfected, allowing the transferee an opportunity to perfect by registration.

Section 76 addresses the situation where the buyer or lessee has also given security over the collateral, and provides a priority rule for the competition between the security interest over the collateral that has attached (or re-attached) under s 37 or 38, and the security interest that was granted by the buyer or lessee. One submission noted that there are a number of drafting difficulties with s 76, and in particular with s 76(3), that prevent it from having full effect. Section 76(3) provides as follows:

(3) A security interest (the priority interest) in goods that is granted by a person who acquires an interest in the property has priority over a security interest in the goods that reattaches under section 37, or is granted by the operation of section 38, if:

(a) the priority interest attaches while the goods are in the possession of the person; and
(b) immediately before the repossession time (referred to in paragraph 37(1)(d) or 38(1)(d)), the priority interest is perfected.

The drafting difficulties identified in the submission are these.

- First, s 76(3)(a) says that the priority interest will only have priority if it attaches while the goods are in possession of the grantor of that interest (ie in the hands of the buyer or lessee). That overlooks the fact that the priority interest may have been granted before the buyer or lessee took possession. I am not aware of any reason why the priority interest should not be entitled to priority just because it was granted before the buyer or lessee obtained possession. The more important point is that the priority interest be granted before the repossession time.

- Secondly, s 76(3)(b) implies, by referring specifically to ss 37(1)(d) and 38(1)(d), that the priority interest can take priority only if the reason for the return of the collateral is the one listed in those sections (which is that the collateral was repossessed because of default). I suspect that this is a drafting error. The expression is defined more broadly in the lead-in text to ss 37(1) and 38(1), and I believe that s 76(3)(b) should simply refer to the repossession time "(referred to in paragraph 37(1) or 38(1))".

**Proposed recommendation 2.92:** That s 76(3) be amended as described above.

### 6.13 Sections 85 and 86 – crops and livestock

Section 85 provides a special priority rule for a security interest that is taken in relation to crop inputs:

A perfected security interest (the **priority interest**) that is granted by a grantor in crops or the proceeds of crops has priority over any other security interest that is granted by the same grantor in the same crops or proceeds if:

(a) the priority interest is granted for value; and

(b) the priority interest is granted to enable the crops to be produced; and

(c) either:

(i) the security agreement providing for the priority interest is made while the crops are growing; or

(ii) the crops are planted during the period of 6 months after the day the security agreement providing for the priority interest is made.

Section 86 provides a similar rule in relation to livestock.

Similar rules can be found in most of the Canadian PPSAs, but not in the NZ PPSA.

Sections 85 and 86 provide a priority position that is similar in some respects to a PMSI, except that the priority is over the crop or livestock that benefits from the input, rather than over the input itself (presumably because the input disappears, as it is used). The provisions are however problematic for a number of reasons.

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156 Eg Sask PPSA ss 34(11) and (12).
• First (as a drafting issue), it is not the security interest itself that "enable[s] the crops to be produced". Rather, it is the input (the funding of which is secured by the security interest) that does this.

• Secondly, the sections suffer from the same problem as PMSIs under s 62, which is the fact that existing secured parties are likely to be and to remain unaware of the existence of the security interest, and that it will rank ahead of them even though it has a later priority time.

• Thirdly, it is not clear how the sections intersect with the priority that is given to security interests that are perfected by control.

One submission drew attention to one particular difference between the rules in ss 85 and 86. The priority rule in s 86 (relating to livestock) does not adversely affect PMSIs – that is, that the rule says that it does not give the input provider’s security interest priority over another security interest, if the other security interest is a PMSI. The rule in s 85 (relating to crops) does not contain this qualification, and so would appear to give the input financier priority over a PMSI in the crops too. The submission suggested that the rules be made consistent.

The Replacement Explanatory Memorandum notes the different approach as between the two sections, but does not explain it.157

The explanation for the distinction may be quite prosaic, in that it could be based on the fact that it would be very difficult to have a PMSI over crops (unless, perhaps, they were purchased as young plants using PMSI finance, and then planted). It is much easier, in contrast, to have a PMSI over livestock. If this is the explanation, then I see no reason in principle why the "(other than a purchase money security interest)" qualification could not be included in s 85 as well. I would be interested to hear the views of others on this.

Proposed recommendation 2.93: None at this stage, pending further consideration.

More generally, ss 85 and 86 could actually make it more difficult for a farmer to raise finance from traditional sources, as the farmer’s bank may be less prepared to provide the farmer with finance because of the risk that it could rank behind a future inputs financier. Alternatively, a farmer’s bank may insist that the farmer not grant any security interests that could benefit from the priority in s 85 or 86, in which case the sections would have no role to play.

One submission also pointed out that the priority rule for accounts financiers in s 64 does not apply to security interests under ss 85 and 86, because they are not PMSIs. The submission said that this is making it difficult for farmers to use their receivables as a source of finance.

Some submissions suggested that ss 85 and 86 be deleted. One submission suggested that suppliers of inputs tend not to take security of the types contemplated by ss 85 and 86. That submission also suggested that the sections had made agricultural finance for banks "more complex and arguably of higher risk". I would be interested to hear further, for example from agribusiness financiers or farming organisations, whether inputs financing of the types allowed for by ss 85 and 86 is thought to be desirable, or whether the sections are thought on balance to adversely affect funding availability for farmers because of the negative implications for their other funding

157 Replacement Explanatory Memorandum, para 3.7.
sources. If the rules are of little or no net benefit, then my preference would be to simplify the Act, and to remove them. This would be consistent with the position in New Zealand.

**Proposed recommendation 2.94:** None at this stage, pending further consideration.
# ANNEXURE A

## GLOSSARY

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<td>A Duggan &amp; D Brown, Australian Personal Property Securities Law (LexisNexis, 2012)</td>
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ANNEXURE B

PRINCIPLES TO GUIDE THE ASSESSMENT OF PROPOSED AMENDMENTS

1. Overall objective

(a) The objective of the Act is to facilitate the creation and enforcement of security interests in personal property, and to provide rules to regulate their legal effect.

Commentary

The rules for the creation of security interests should not attempt to prescribe the form that parties must use. Rather, the Act should simply identify the outcome that a transaction needs to achieve, if it is to create a security interest that is effective for the purposes of the Act, and otherwise leave it to the parties to choose how they want to document the arrangement between them.

The rules regarding the legal effect of a security interest should encompass the effectiveness of the security interest as against third parties such as other secured parties, buyers and lessees.

The rules regarding enforcement should be facilitative, in that they should not limit the enforcement remedies that the parties may agree to include in their transaction. Rather, the rules should provide a set of enforcement remedies that are available for a secured party to use in transactions where the security agreement itself does not contain enforcement mechanisms, or instead of contractually agreed remedies if the secured party prefers.

The Act should also deal with appropriate ancillary matters, such as:

- how to decide when the Act applies; and
- matters relating to the operation of the register.

(b) The focus of the Act should be on interests that in substance secure obligations. When considering the extent to which the Act should also apply to interests in property that do not secure obligations, the following factors should be taken into account:

- whether the interest is of a type that is sufficiently common in or important to our economy that it is appropriate to consider extending the regime to include it; and
- whether the overall benefit of including the interest in the Act (or in chosen aspects of the Act) will outweigh any detriment from doing so.

Commentary

One of the key "mischiefs" that is the target of legislation such as the Act is the so-called "evil of apparent ownership" – the risk that a third party may be misled by the apparent owner of property into believing that the apparent owner can give the third party a better interest in the property than is actually possible. This risk can arise if the third party has no independent means to determine whether another person might already hold a conflicting interest in the property. The Act aims to reduce this risk, by providing that a secured party puts its security interest
at risk if it does not take steps that make it possible for a third party to learn of its existence. Those steps are referred to in the Act as "perfection".

There are many other types of circumstances, beyond the granting of security interests, in which a person can appear to have a greater interest in property than is actually the case. For example, a person may simply be in possession of another person’s tangible property, either temporarily or on a long-term basis. A person may hold another person’s intangible property as custodian, or as their nominee. It would not be practicable for the Act to deal comprehensively with all circumstances in which apparent ownership of property is divorced from its true ownership. This reality was acknowledged by the Law Reform Commission of Saskatchewan in its report "Proposals for a Saskatchewan Personal Property Security Act" in July 1977, in which it made the following observation:

It is totally unrealistic to attempt to bring within the scope of the Act every kind of transaction in which deception results from a separation of interest and appearance of interest. However, it is realistic to include in the registration and perfection system of the Act certain types of transactions which, because of their commercial importance, are likely to continue to produce significant disruption if left out.

Rather than ignore other types of potentially-misleading transactions completely, however, the practice in jurisdictions that have legislation like the Act has been to include a subset of those other transactions within the legislation. In some jurisdictions (such as Saskatchewan), the selected subset consists of transactions which, as noted in the quotation above, are likely to produce significant disruption if they are left out, because of their commercial importance. In other jurisdictions, the selection has been adopted from predecessor legislation, without necessarily undertaking a full fresh scrutiny of whether the factors that led to that selection in the other jurisdiction were also relevant in the adopting jurisdiction.

When considering proposals to amend s 12(3), we should consider whether the proposed amendments would help to ensure that s 12(3) captures the appropriate types of interests, and only the appropriate types of interests.

2. Balance

The rules should strike an appropriate balance between the interests of secured parties, and the interests of third parties that take or may want to take a competing interest in collateral, such as:

- other secured parties; or
- buyers or lessees.

Commentary

This is the principle that is likely to inspire the most debate. Different market sectors will understandably want to ensure that their commercial positions remain as robust as possible under the Act. However, it will not always be possible to structure the rules in the Act in a way that provides all parties with the level of protection that they desire. Indeed, in many situations (such as the application of the priority or taking free rules), it may only be possible to protect one person at the expense of another. The rules need to find a balance between the legitimate expectations of the affected stakeholders.

3. Simplicity

Each rule should be expressed as simply as is possible without compromising the ability of the rule to achieve its purpose. It should be clear for each rule what the purpose of the
rule is, and how that purpose fits with the overall purposes of the regime. The rules should apply consistently, across all types of personal property and security interest, unless there are good reasons to the contrary (such as a desire to facilitate particular business practices or policy objectives). Taken as a whole, the rules should produce clear and predictable outcomes for business and other stakeholders.

Commentary

It is important to express rules as simply as is possible, so that it is as easy as possible for readers to understand what the rules mean, and how they can work with them.

Commerce, however, is complex. The Act needs to reflect and respond to that reality, and not stifle commercial creativity by imposing "one size fits all" requirements. Because the complexity of commercial life will necessarily require that there be corresponding complexity in the Act, it will be important to monitor the extent of that complexity, and to resist the urge to over-complicate the Act by providing exceptions or sub-rules to deal with particular fact patterns, or by including "avoidance of doubt" clarifications, unless they are truly necessary. As far as possible, potential uncertainties or complexities should be dealt with through careful formulation of the primary rules, rather than by means of exceptions or supplementary qualifications.

This is again a question of finding the right balance. We should resist the urge to over-complicate the Act, but also be mindful of the need, to quote Albert Einstein, to "make everything as simple as possible, but not simpler".

4. Comprehensiveness

The rules should be as all-embracing as possible. They should apply to all types of personal property and all types of security interest, unless there are clear policy reasons for an exception.

Commentary

This is a broader application of the "simplicity" principle. Carve-outs from the Act complicate the Act itself. They can also complicate outcomes for those who want to take an interest in the property, or to enter into a transaction, that is carved out. This is because excluding a type of property or transaction from the Act does not mean that the property or transaction can then operate free of any legal rules at all. Rather, it means that a different set of rules need to be identified and applied, and that could well result in increased complexity and uncertainty for those involved, rather than less.

5. Flexibility

The rules should be as flexible as possible. They should accommodate current market structures and business practices, but also be flexible enough to respond to changes to them. They should allow parties the freedom to structure their agreements as they see fit, unless there are policy reasons to the contrary (such as the need to protect consumers). They should include as few formal requirements as possible.

Commentary

Some care needs to be taken in the pursuit of this principle, as too much flexibility can degenerate into uncertainty. Also, while it is important that the Act not focus entirely on current market practices and conditions, and that it be able to accommodate new developments as well, the primary focus of the Act should be on ensuring that it produces appropriate and meaningful outcomes for Australian businesses and consumers today.
6. Transparency

The rules should aim to provide transparency in relation to the existence of security interests, through mechanisms that enable third parties to determine whether an item of a person’s property may be subject to a security interest.

Commentary

This principle targets the “evil of apparent ownership” mentioned earlier. A key objective of the Act should be to provide mechanisms that make it possible for third parties to determine whether a security interest may exist over a particular item of property. This is the role performed by the three main modes of perfection under the Act – registration, possession and control.

A third party will however not always be able to detect whether an item of property is subject to a perfected security interest. For example, the Act provides for circumstances in which a security interest will be deemed to be perfected, either temporarily or permanently, in a manner that will not be apparent to third parties. It is also possible for a security interest to be perfected by control in a manner that is not visible to outsiders. And even registration provides no more than an indication that a security interest might be attached to property. Trade-offs of this kind are inevitable, given the need to balance the practicalities of the perfection process against the information needs of third parties. When assessing the mechanics of the various modes of perfection, however, it is important to remember why perfection is there, and to ask whether it is achieving its purpose.

7. Fit

The rules should be able to function in harmony with the balance of our law.

Commentary

The Act is not a self-contained set of rules that operate in isolation from the balance of our laws. Rather, the Act is just one component of our legal system generally, and needs to be able to function in harmony with it.

The Commonwealth Government has gone to considerably lengths to amend other legislation to adopt the terminology and concepts of the Act. State and Territory Governments have done this to a rather lesser degree.

The Act needs to be able to produce meaningful outcomes when interpreted and applied against the background of our laws generally. Other parts of Australia's commercial law framework, and the expectations that underpin that law, are very different to the laws and expectations that applied in the United States in the 1950s, when Article 9 was introduced. The same can be said (albeit to a lesser extent) in relation to the corresponding legislation in Canada and New Zealand. Terminology or structures that achieve meaningful outcomes in the overseas legislation may not work here. The drafting of the Act needs to take this reality into account.

This is clearly something of an aspirational set of targets. The complexity and innovativeness of the Australian economy, together with the inherent ambiguity of the English language, make any of these principles difficult if not impossible to realise in full. There is a degree of overlap between some of the principles, but others are in tension with each other, in that it may only be possible to pursue one principle in some circumstances if this is done at the expense of another. Where these conflicts do arise, they will need to be resolved by determining where the appropriate balance lies, looking back as needed to the over-arching objectives referred to in Part 6 of this report.