CONFERENCE PRESENTATIONS

Crumble in the jungle

lessons from the Crunch

Cover photo courtesy of Imogen Loxton

Sheraton Mirage Resort, Gold Coast **31 July - 1 August 2009**

Presented by

26th Annual Banking & Financial Services Law & Practice Conference

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FRIDAY 31st JULY, 2009

9.00am - 10.30am

Opening Plenary
Good Faith in Contracts in financial services
Implied term or general duty? What is good faith? The impacts on the exercise of rights. Possibilities for exclusion.

Chair: Diccon Loxton, Partner, Allens Arthur Robinson, Sydney
Speakers: Hon. Justice Paul de Jersey, Supreme Court of Queensland, Brisbane
Dr. Elisabeth Peden, Professor, Faculty of Law, University of Sydney, Sydney
Hon. Justice Peter Blanchard, New Zealand Supreme Court, Wellington

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11.00am - 12.30pm

Concurrent Sessions 1A & 1B

(1A) **National Credit Reform Take 3: The Ascendance of the Commonwealth**
The Federal Government has announced a two-phase plan to implement the COAG agreement for the Federal takeover of credit regulation, with Phase One legislation to be in place by the middle of this year. The plan is not confined to consumer credit and includes investment property lending, margin lending and the licensing of lenders, advisers and brokers. Phase Two includes the proposed regulation of the provision of credit to small businesses. Speakers will provide Government, private practice and industry perspectives on what the changes will mean, including future policy directions. The session will also include a discussion of related aspects of the proposed Australian Consumer Law.

Chair: Elisabeth Wentworth, Barrister, Victorian Bar, Melbourne
Speakers: Mark Sneddon, Partner, Clayton Utz, Melbourne
Alix Gallo, Head, Consumer Credit Unit, Corporations & Financial Services Division, Commonwealth Treasury, Canberra
Comments: Steve Edwards, Director, SME Associates, Sydney

Friday 31st July continued ....

11.00am - 12.30pm	(1B)	**Set-off as a security device** *Set-off usually only becomes crucial on insolvency: if everybody could pay, there would be no need for the protection of set-off. The speakers will explore the ambit of set-off and the extent to which different types of set-off operate as effective security". They will discuss chinks in the armoury of set-off which may prevent set-off being used to reduce exposure, and will explore whether it is always available on insolvency, against attaching creditors, assignees and other interveners. The speakers will discuss priority issues that arise with set-off and will compare different set-off regimes under the common law, the PPSA in New Zealand and the proposed Australian personal property securities legislation.*
	Chair:	Jason Morris, Partner, Allens Arthur Robinson, Melbourne
	Speakers:	Associate Prof. Sheelagh McCracken, Applied Finance Centre, Macquarie University, Sydney Jason Boyes, Partner, Buddle Findlay, Wellington
1.30pm - 3.00pm		***Concurrent Sessions 2A & 2B***
	(2A)	**Capital raising by banks and other financial institutions following the credit crisis** *(Panel presentation – no papers available)* *This session will look at the development of alternative funding sources for the finance sector. Consideration will be given to the benefits and disadvantages of Government support provided through, for example, government guarantees and the Australian AOFM arrangements. It will also consider the longer term solutions, including whether securitisation will remain a funding tool and alternative funding sources, such as covered bonds and the treatment of such instruments in different jurisdictions. Finally, greater Government regulation of the finance sector and the impact this may have on capital raising will be considered.*
	Chair:	Angela Flannery, Partner, Clayton Utz, Sydney
	Speakers:	Therese McCarthy-Hockey, Treasurer: Australia & New Zealand Deutsche Bank AG, Sydney Jason Elphick, General Counsel - Capital & Funding, National Australia Bank, Melbourne Ross Pennington, Partner, Russell McVeagh, Auckland
1.30pm - 3.00pm	(2B)	**Privacy Law in Evolution: Across the Pacific** *This session gives an overview of proposed changes to the Privacy laws of Australia and New Zealand; focusing on the differences and similarities in the evolution of the laws in the two countries; and considering the practical implications of proposed changes, particularly in regard to credit reporting.*
	Chair:	Amanda Parshall, General Counsel, HSBC Bank Australia Ltd. Sydney
	Speakers:	Karen Curtis, Australian Privacy Commissioner, Canberra Marie Shroff, New Zealand Privacy Commissioner, Wellington Katherine Forrest, Partner, Mallesons Stephen Jaques, Melbourne

Friday 31 July continued ....

3.30pm - 5.00pm		*Concurrent Session 3A & 3B*
	(3A)	**Hostage to the Vibe – the Future of Statutory Unconscionability in Banking Transactions** • *Foundations of unconscionability in statutory and non-statutory law in Australia and New Zealand* • *Wider policy and regulatory trends in unconscionability* • *Banking-specific regulatory investigations and authorities* • *Areas of concern for future litigation* • *Approaches for risk minimization*
	Chair:	Adam Thatcher, Partner, Allens Arthur Robinson, Brisbane
	Speakers:	Prof. Bryan Horrigan, Professor & Associate Dean (Research) Monash University, Melbourne Hon. Justice Andrew Greenwood, Federal Court of Australia, Brisbane Hon. Justice Peter Blanchard, New Zealand Supreme Court, Wellington
3.30pm - 5.00pm	(3B)	**Securities Lending – Lessons Learnt** (papers not available) *The speakers will address some of the practical and legal issues arising in relation to the insolvency of a business engaged in securities lending, and in particular under the terms of the standard Australian Master Securities Lending Agreement (or AMSLA).* *These issues include:* o *What is the true nature of a loan of securities?* o *When can an AMSLA be closed out, and by whom?* o *How does the netting mechanism under the AMSLA operate in an insolvency scenario?"*
	Chair:	Richard Fawcett, Partner, Blake Dawson, Sydney
	Speakers:	Salvatore Algeri, Partner, Deloitte Touche Tohmatsu, Melbourne Ross McClymont, Partner, Blake Dawson, Melbourne

SATURDAY 1st AUGUST, 2009

8.45am - 10.00am	(Plenary)	**Director Duties and insolvent trading – the existing law and its effects** *The speakers will consider the current insolvent trading and reckless trading laws that apply in Australia and New Zealand (respectively) and whether or not such laws require amendment having regard to, amongst other things, similar laws in the UK and US, the policy objectives of such laws and the fact that there is no distinction between insolvent trading laws that apply to directors of private companies and those that apply to publicly listed companies. The session will also include discussion of the practical effects of the current insolvent trading laws in the context of distressed companies and the course of action available to the directors of such companies*
	Chair:	Jonathan Oldham, Partner, Mallesons Stephen Jaques, Melbourne
	Speakers:	John Sheahan SC, 5 Wentworth Chambers, Sydney James Douglas, Partner, Minter Ellison Rudd Watts, Wellington Margaret Cole, Group General Counsel, Babcock & Brown Aust. P/L, Sydney
10.15am - 11.35am	(Plenary)	**For whom the bell tolls - lenders, directors and workouts following Bell**
	Chair:	John Evans, Partner, Henry Davis York, Sydney
	Speakers:	David Clarke, CEO, Investec Bank (Australia) Margaret Cole, Group General Counsel, Babcock & Brown Aust. P/L, Sydney Prof. John Stumbles, Faculty of Law, University of Technology, Sydney Simon Lynch, Partner, Allens Arthur Robinson, Melbourne Mark Korda, Partner, KordaMentha, Melbourne
11.35am - 12.50pm		*Concurrent Sessions 4A & 4B*
	(4A)	**PPS: Specific Issues - Chaos In The Making.....**
	Chair:	Michael Robinson, Partner, Simpson Grierson, Auckland
	Speakers:	David Turner, Victorian Bar, Melbourne Patrick Lowden, Partner, Freehills, Sydney Steve Flynn, Special Counsel, Simpson Grierson, Wellington
11.35am - 12.50pm	(4B)	**NZ Finance Companies "The Way Forward"** *This session will look at the New Zealand Finance company scene following recent collapses, what happened, some of the contributing factors and where the industry goes from here.*
	Chair:	Dennis Church, General Manager - Corporate Trustee Services, Public Trust, Auckland
	Speakers:	Grant Graham, Partner, KordaMentha, Auckland Clynton Hardy, Chairman, Trustee Corporations Association of New Zealand Inc, Wellington Ian Woolford, Manager, Financial System Policy, Reserve Bank of New Zealand

Saturday 1 August continued ....

1.30pm - 2.45pm	(Plenary)	**Indefeasibility and All Advances Mortgages: Are they a thing of the past?** *This session examines the latest developments in New Zealand and Australia in the area of mortgage security, particularly all advances mortgages. There have been a number of recent cases in both New Zealand and Australia which have put into question whether lenders are able to rely on them as granting an indefeasible interest*
	Chair:	Mariette van Ryn, General Manager, Regulatory Affairs, Customer Advocacy & General Counsel Westpac New Zealand Limited, Auckland
	Speakers:	Emeritus Prof. Peter Butt, School of Law, Sydney University, Sydney Hon. Justice Margaret Stone, Federal Court of Australia, Sydney Michael Robinson, Partner, Simpson Grierson, Auckland
3.00pm - 4.30pm	(Plenary)	**The Credit Crunch - Lessons for Lawyers** (P*anel session*) *Much has been written and said about the causes of the Credit Crunch. But what of lawyers (including lawmakers)? What was our role in its causes? Were we asleep at the wheel, or were we all too busy making hay while the sun shone? To what extent where those in the law responsible and did we have a broader role that we didn't press? How should the answers to these questions inform our behaviour, as lawyers, going forward? How can we resist the "private equiteer effect" in the next rising market?*
	Chair:	Nuncio D'Angelo, Partner, Mallesons Stephen Jaques, Sydney
	Speakers:	Ian Greer, Managing Director, Standard & Poor's, Sydney Tim L'Estrange, Group General Manager, Governance, ANZ Banking Group, Melbourne Bill Moss, Chairman & Founder, Moss Capital, and Chairman, PBB Advisory, Sydney Michael Pelly, Legal Affairs Journalist, The Australian, Sydney

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Good Faith in Contracts in financial services

Chair:
Diccon Loxton
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Speakers:
Hon. Justice Paul de Jersey
Supreme Court of Queensland, Brisbane

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Good faith in contracts in financial services

The Hon Paul de Jersey AC
Chief Justice
Supreme Court of Queensland
Brisbane

26th Annual Banking and Financial Services Law and Practice Conference
Gold Coast
Friday 31 July 2009, 9am
"Good faith in contracts in financial services"

The Hon Paul de Jersey AC
Chief Justice

1. In her illuminating paper, Professor Peden makes a powerful case for the propositions, first, that any implication of a term into a commercial contract is unnecessary, because of the implicit obligation of good faith necessarily inherent; and second, that the now established UK position – where "good faith" means honesty and absence of caprice, together with rationality in the Wednesbury sense – is to be preferred over a developing Australian jurisprudence which extends the concept to embrace objective reasonableness as well.

2. Distinct contrast between the 1992 approach of the New South Wales Court of Appeal in *Renard Constructions (ME) Pty Ltd v Minister for Public Works* (1992) 26 NSWLR 234, equating good faith with reasonableness, and the recently expressed approach of the English Court of Appeal in *Socimer International Bank Ltd v Standard Bank Ltd* (2008) 1 Lloyd's Rep 558 will give trial judges and intermediate appeal courts in this country particular cause for concern, in the context of what the High Court said in *Farah Constructions Pty Limited v Say-Dee Pty Limited* (2007) 230 CLR 89, 151-2:

   > "Intermediate appellate courts and trial judges in Australia should not depart from decisions in intermediate appellate courts in another jurisdiction on the interpretation of Commonwealth legislation or uniform national legislation unless they are convinced that the interpretation is plainly wrong. Since there is a common law of Australia rather than of each Australian jurisdiction, the same principle applies in relation to non-statutory law."

That is because much of the judicial utterance in this country, *Renard* and other New South Wales cases aside, suggests something of a preference for the English position.

3. An orthodox Australian approach to the attenuated English duty of good faith would see it arising as a matter of the construction of a contract. It is really another expression of the obligation to cooperate in the performance of a contract. That necessarily entails acting honestly, not capriciously, not irrationally. Going back to S*ecured Income Real Estate (Australia) Ltd v St Martin's Investment Pty Ltd* (1979) 144 CLR 596, 607, we see Sir Anthony Mason speaking of that duty as one arising on the proper construction of the contract. He said:

> "But it is common ground that the contract imposed an implied obligation on each party to do all that was reasonably necessary to secure performance of the contract. As Lord Blackburn said in *Mackay v Dick* (1881) 6 App. Cas. 251, 263:
>
> > 'As a general rule … where in a written contract it appears that both parties have agreed that something shall be done, which cannot effectually be done unless both concur in doing it, the construction of the contract is that each agrees to do all that is necessary to be done on his part for the carrying out of that thing, though there may be no express words to that effect'.
>
> It is not to be thought that this rule of construction is confined to the imposition of an obligation on one contracting party to co-operate in doing all that is necessary to be done for the performance by the other party of his obligations under the contract. As Griffith CJ said in *Butt v M'Donald* (1896) 7 QLJ 68, 70-1:
>
> > 'It is a general rule applicable to every contract that each party agrees, by implication, to do all such things as are necessary on his part to enable the other party to have the benefit of the contract.'"

4. As we know, the High Court of Australia has yet to consider this issue. It was not determined in *Royal Botanical Gardens and Domain Trust v South Sydney City Council* (2002) 186 ALR 289, because it was not a live issue in that case. The good faith sceptics might however have taken some heart from obiter remarks of two justices who have since retired. Justice Kirby said (p 312):

> "… In Australia, such an implied term appears to conflict with fundamental notions of caveat emptor that are inherent (statute and equitable intervention apart) in common law conceptions of economic freedom. It also appears to be inconsistent with the law as it has developed in this country in respect of the introduction of implied terms into written contracts which the parties have omitted to include."

And Justice Callinan said this (p 327)"

> "… It is unnecessary to answer the questions raised by the rather far-reaching contentions of the appellant, and for which, it says, *Alcatel Australia Ltd v Scarcella* and *Burger King Corp v Hungry Jacks Pty Ltd* stand as authorities: whether both in performing obligations and exercising rights under a contract, all parties owe to one another a duty of good faith; and, the extent to which, if such were to be the law, a duty of good faith might deny a party an opportunistic or commercial exercise of an otherwise lawful commercial right."

5. Professor Peden has entitled one of her essays in this area: "When common law trumps equity: the rise of good faith and reasonableness and the demise of unconscionability". It is interesting to acknowledge that the High Court has resisted attempts to engraft equitable doctrines inappropriately onto other, well-established, common law landscapes.

   In *Tanwar Enterprises Pty Limited v Cauchi & Ors* (2004) 217 CLR 315, the High Court rejected a contention that a vendor of real property was acting unconscionably when exercising a right to terminate a contract upon the purchaser's default in completing in accordance with an essential time stipulation (where, by the time of termination, the purchase could have been completed).

   The question re-emerged in *Romanos & Anor v Pentagold Investments Pty Limited & Anor* (2003) 217 CLR 367, 375 where the High Court observed that "equity does not intervene in such a case to reshape contractual relations in a form the court thinks more reasonable or fair where subsequent events have rendered the situation of one side more favourable than that of the other side".

In *ACCC v Berbatis Holdings Pty Ltd* (2003) 214 CLR 51, Gleeson CJ emphasized (pp 64-5) that, absent exploitation of a specially disadvantaged party, the other will not behave unconscionably by robustly asserting his or her superior bargaining position. The Chief Justice said this:

> "A person is not in a position of relevant disadvantage, constitutional, situational, or otherwise, simply because of inequality of bargaining power. Many, perhaps even most, contracts are made between parties of unequal bargaining power, and good conscience does not require parties to contractual negotiations to forfeit their advantages, or neglect their own interests …
>
> Unconscientious exploitation of another's inability, or diminished ability, to conserve his or her own interests is not to be confused with taking advantage of a superior bargaining position …"

He spoke uncritically in this context of parties to commercial negotiations using their bargaining power to "extract concessions from other parties" observing "that is the stuff of ordinary commercial dealing". On one view it is odd the arguable reach of equity meant such confirmations were necessary.

6. Two years on after *Renard Constructions*, the Victorian Court of Appeal touched upon these issues in *Esso Australia Resources Pty Ltd v Southern Pacific Petroleum NL* (2005) VSCA 228. The case concerned the exercise of a right in one joint venturer to assign its interest, without consent, to a related corporation, provided it guaranteed the assignee's obligations. In this case, the assignee was a technically related corporation, and the assignment was made at a time when the assignor's guarantee was worthless, because of the imminent liquidation of the assignor. *Esso* argued that the assignor thereby breached an implied duty of good faith.

   Buchanan J wrote the principal judgment and did not conclude whether such a duty was imposed, on the basis that even if it was, it was not breached because *Esso*

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gained a financially viable new co-venturer, losing one which had become financially moribund. But he did say this (para 29):

> "The duty of good faith, unlike the duty imposed upon a fiduciary, is not a duty to prefer the interests of the other contracting party, but rather to have due regard to the interests of both parties and the benefits afforded by the contract."

which is rather reminiscent of what Sir Anthony Mason said in *Secured Income Real Estate*.

Chief Justice Warren echoed the concern of many when she spoke of an erosion of certainty in commercial transactions (para 3):

> "If a duty of good faith exists, it really means that there is a standard of contractual conduct that should be met. The difficulty is that the standard is nebulous. Therefore, the current reticence attending the application and recognition of a duty of good faith probably lies as much with the vagueness and imprecision inherent in defining commercial morality. The modern law of contract has developed on the premise of achieving certainty in commerce. If good faith is not readily capable of definition then that certainty is undermined."

7. Such concepts are intrinsically indeterminate. In *Service Station Association Ltd v Berg Bennett and Associates Pty Ltd* (1993) 45 FCR 84, 92 Gummow J spoke of an American view that "the good faith performance doctrine may appear as a licence for the exercise of judicial … intuition, resulting in unpredictable and inconsistent applications".

Some of the issues which could arise in the commercial context are of quite serious complexion, highly relevant to day-to-day operations. For example, would good faith oblige a mortgagee bank, in possession of a valuation at a figure substantially lower than a customer purchaser is intending to pay for a property to disclose that valuation to the customer? Could threatening to exercise a legally accrued right, in order to encourage the other party to renegotiate a transaction, ever fall into the bad

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faith category? A rigorous insistence on legal rights may be considered tough, but could it ever evidence a lack of bona fides?

What is "fair" and what is "just" in the abstract sense, is informed by established community values. Some will argue that if these are to be identified, who better than a judge to do so. But while I am obviously not suggesting courts are not in touch with their communities, the fact remains that judges are not necessarily well-equipped to determine prevailing community values and social attitudes.

In *Dietrich v R* (1992) 177 CLR 292, 319, Brennan J identified the "contemporary values" which should relevantly inform the judicial process, as not "the transient notions which emerge in reaction to a particular event or which are inspired by a publicity campaign conducted by an interest group. They are the relatively permanent values of the Australian community." Lord Steyn has spoken in the House of Lords of the fashioning of rights by reference to what a judge "reasonably believes the ordinary citizen would regard as right" (*McFarlane v Tayside Health Board* (2000) 2 AC 59,82).

The question remaining is how those relevant values are to be gauged.

8. If a duty of good faith, inhering in a contract, is limited to the mutual obligation of the parties to cooperate to ensure its due performance, then there could be no room for complaint. Similarly, if the duty is of the English variety, commanding honesty and rationality, there could be no complaint, because they are no more than incidents of the Secured Investments type obligation. It is the importation of objective reasonableness which injects considerable potential uncertainty into a commercial contract framework.

9. The question whether merely negotiating parties, who have not reached a binding agreement, should be bound to act in good faith is even more controversial. In

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Coalcliff Collieries Pty Ltd v Sijehema (1991) 24 NSWLR 1, the New South Wales Court of Appeal rejected an obligation, to "proceed in good faith to consult together upon the formulation of a more comprehensive and detailed joint venture agreement", as too illusory, vague and uncertain to be enforceable. Yet the court left open the possibility that depending on its precise terms, a promise to negotiate in good faith could sometimes be binding. This realm is very speculative: what agreement would have eventuated, if any, had the obligation not been breached? What damages, if more than nominal, would flow?

The United Kingdom has firmly turned its face against such an obligation. The House of Lords rejected the possibility in *Walford v Miles* (1992) 2 AC 128, holding that a duty to negotiate in good faith would be unworkable in practice, and inherently inconsistent with the position of the negotiating party, since while the parties were in negotiation either of them could break off at any time and for any reason. There is obviously much to commend that view. The law has made substantial inroads into freedom of contract. The criminal law aside, surely there is not any need to intrude into commercial negotiation.

10. When I refer to existing inroads, I especially have in mind obligations of good faith statutorily imposed. But there is a range of situations in commercial law where issues of good faith have long arisen. Gummow J offered some examples in *Service Station Association Ltd v Berg Bennett and Associates Pty Limited* (1993) 45 FCR 84, 91-2: the obligation of a fiduciary to act in good faith towards the principal; the relationship between partners; a mortgagee exercising powers consequent on a mortgagor's default; the bona fide purchaser of a legal estate; the equitable doctrines of undue influence and unconscionability. Also, the statute law is sprinkled with references to obligations of good faith. The corporations legislation, for example, obliges directors to act in good faith in their company's interests (*Corporations Act* s 181).

The challenge facing the courts is to develop and maintain a legal framework which is nevertheless as comprehensible as possible.

11. The topic as presented in the program also raises whether a duty of good faith which extends, say, to objective reasonableness, might effectively be excluded. I commend an interesting, comprehensive article on this subject by Dr Bill Dixon, who happens to be a Queenslander, published in (2007) 35 ABLR 110 ("Can the common law obligation of good faith be contractually excluded?").

My present feeling is that an attempt contractually to exclude the duty to act honestly would fail. But what foolhardy entity would be prepared to contract on that basis anyway? It would fail, as would an attempt to exclude an obligation to cooperate to ensure the performance of a contract, because those obligations are essential to its being a contract: they are inherent, necessary characteristics of a contract in the sense that absent those obligations, there would be no contract. The same could be said of the obligation to act reasonably in the Wednesbury sense: that equates to an obligation to act rationally – though not necessarily with perfect reasonableness as may objectively be assessed.

On the other hand, the possibility of contractually excluding an obligation to act reasonably in that latter objective sense is much more arguably open. Notwithstanding *Renard Constructions* and some of the following cases, it has never been the case that a contracting party is impliedly obliged to act reasonably in that sense. That is because such an implication would not be necessary to render a contract efficacious. It helps to go back to cases like *BP Refinery (Westernport) Pty Ltd v Shire of Hastings* (1977) 180 CLR 206 (as did Rix LJ in *Socimer*) for the constraint upon the implication of contractual terms as a matter of fact. It is also helpful to remember cases like *Meehan v Jones* (1982) 149 CLR 571, where the High Court powerfully debunked a contention that a purchaser was implicitly obliged to act reasonably in seeking finance to satisfy a "subject to finance" provision.

I should qualify what I have said about excluding inherent obligations to act in good faith by referring to "sole discretion" clauses. There is a recent example where such a provision was held to exclude even an obligation to act in good faith. It is *Theiss Contractors Pty Ltd v Placer (Granny Smith) Pty Ltd* (2000) 16 BCL 255, where *Placer* terminated contracts for open cut mining by *Theiss*. *Placer* was entitled to do that, for whatever reason, in which event *Theiss* would be entitled to compensation. The primary Judge rejected the contention that *Placer* was obliged to act in good faith, describing its discretion to terminate as "absolute and uncontrolled", and the primary Judge also rejected a contention that *Placer* was obliged to act reasonably. He did that as a matter of construction (p 100) rather than by reference to the implication of terms. An appeal succeeded, but on another point (2000) 16 BCL 255).

Dr Dixon raises the possibility of express provision in a contract that the parties are not constrained to act reasonably in the broader objective sense, so as to negate the implication of a contradictory obligation; though again, commercial parties may prefer not to have such a provision spelt out.

The author finally refers to "entire agreement" clauses. The authorities are in disarray as to whether such provisions are apt to exclude implicit obligations of good faith, though I venture it is doubtful that such a provision would be effective to exclude an inherent obligation to act in good faith.

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Good faith in contracts in financial services

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Why Contractual Good Faith is a matter of construction

Banking and Financial Services Law Association Conference 2009

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Why contractual 'good faith' ought to be seen as a matter of construction and not implication – and why it matters!

Elisabeth Peden*

Implied terms of good faith in relation to express contractual rights and discretions have been making life interesting for those involved in commercial litigation in Australia for almost 20 years. These rights and discretions appear in commercial contracts, where consumer legislation is not relevant and the only possible fetter on the exercise of these rights and discretions would be found in common law or equitable doctrines. From the recent cases, the two likely fetters on rights and discretions are good faith and reasonableness. With those two fetters seem to arise two areas of confusion:

- how these fetters of good faith and reasonableness are incorporated into contracts, when they are not express; and
- what these fetters mean.

In relation to the latter point, recent Australian cases support the idea that 'good faith' is synonymous with 'reasonableness'[1] or that there are two co-extensive duties, one of good faith and the other of reasonableness. There is no judicial explanation of why good faith and reasonableness should restrict rights (such as termination rights), and thereby enter the territory of relief against forfeiture and unconscionability. Yet, recent Australian cases adopt this approach.[2] Some cases even see a merging of equity and common law in the development of the fetter of the implied term of good faith.[3] It is therefore interesting that a different approach is being taken in decisions of the

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* Professor of Law, University of Sydney; Barrister, 13th Floor St James Hall, 169 Phillip Street, Sydney. This paper draws on Peden, 'Implicit good faith' - or do we still need an implied term of good faith? (2009) 25 *JCL* 50.

1 See *Renard Constructions (ME) Pty Ltd v Minister for Public Works* (1992) 26 NSWLR 234 and cases following that decision, such as *Vodafone Pacific Ltd v Mobile Innovations Ltd* [2004] NSWCA 15; *JK Keir Pty Ltd v Priority Management Systems Pty Ltd* [2007] NSWSC 789 per Rein AJ at paragraph [27]; *Mangrove Mountain Quarries Pty Ltd v Barlow* [2007] NSWSC 492 at paragraph [27] per Windeyer J. In *Nauru Phosphate Royalties Trust (Receivers and Managers appointed) & Business Australia Capital Mortgage Pty Ltd v Nauru Phosphate Royalties Trust* [2008] NSWSC 916 (5 September 2008), where Einstein J states at para [43] "The effect of the Court of Appeal … in *Burger King* [was to] … collapse any distinction between contractual obligations of good faith and obligations of reasonableness…"

2 See eg *Renard Constructions (ME) Pty Ltd v Minister for Public Works* (1992) 26 NSWLR 234.

3 See eg *Harbourside Catering Pty Ltd v TMG Developments Pty Ltd* [2007] NSWSC 1375 at para [52], where Palmer J states that the equitable principle controlling the exercise of contractual rights under the "rubric" of

English Court of Appeal, where good faith is aligned with honesty and rationality, and distinguished from reasonable care or objective reasonableness.

The second problem is the method of incorporation of restrictions of good faith or reasonableness. In both England and Australia the approach is to imply a term requiring good faith or reasonable exercise of rights or powers.[4] If, as this paper suggests, good faith is implicit or inherent in the institution of contract law, then an implication of good faith is unnecessary and confusing. If the implication incorporates a higher obligation of objectively reasonable behaviour then a clear explanation would be expected, but has not been forthcoming from the courts. Furthermore, this paper suggests that any fetter on an express right or discretion can instead be achieved by construction, rather than implication of a term.

Very recently in Singapore, the Court of Appeal decided not to imply an obligation of good faith into an agency contract for placement of shares. Having considered developments in Australia, US, England and Canada, the court explained its decision against incorporating a term of good faith:[5]

> "Much clarification is required, even on a theoretical level. Needless to say, under the theoretical foundations as well as the structure of this doctrine are settled, it would inadvisable (to say the least) to even attempt to apply it in the practical sphere."

Before this 'second problem' is tackled, it is important to consider how this issue is of relevance to the law concerning banking and financial institutions. Before the recent developments about implied terms of good faith and reasonableness, banking lawyers were familiar with the notion of 'good faith' in the context of mortgagee's powers of sale. While legislation informs what behaviour is required,[6] it is also appreciated that the mortgagee must exercise the power 'in good faith'. There has never been any discussion of implied terms in that context, nor a suggestion that 'good faith' meant 'reasonableness'.

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unconscionable conduct has been "re-labelled" the duty to act in good faith; *Vodafone Pacific Ltd v Mobile Innovations Ltd* where Giles JA states: "depending on how the content of the obligation of good faith becomes settled, if it does, contract may take over from equitable principle.": [2004] NSWCA 15, at para [217]. See also Elisabeth Peden, "When common law trumps equity: the rise of good faith and reasonableness and the demise of unconscionability" (2005) 21 *JCL* 226.

4 See eg Elisabeth Peden, *Good Faith in the Performance of Contracts*, 2003, LexisNexis Butterworths, Chapter 6.

5 *Ng Giap Hon v Westcomb Securities Pte Ltd* [2009] SGCA 19, at paragraph [60].

6 See for example, section 85 *Property Law Act* (Qld) ("duty… to take reasonable care to ensure that the property is sold at the market value"); s420A(1) *Corporations Act* 2001 (Cth) ("controller must take all reasonable care to sell the property…").

However, good faith appears in banking contexts in other areas also, such as where a discretion is provided to a contracting party, such as a bank being entitled to vary interest rates. In such contexts, it is now important to be aware of the potential impact of obligations of good faith and reasonableness.

In order to develop the argument that good faith ought to be seen as a matter of construction and not implication, this paper draws on the 2008 decision of the English Court of Appeal in *Socimer International Bank Ltd v Standard Bank Ltd*[7] as the vehicle for discussing these issues. In *Socimer*, the Court of Appeal decided that:

1. Good faith is implicit in contracts.
2. The meaning of good faith is honesty and operates to control issues of self-interest.
3. Generally, discretions will be limited by good faith or honesty.
4. A restriction on a discretion in the form of good faith or an obligation of reasonableness will be incorporated as an implied term.

Australian cases appear to disagree with all except point 4. I agree with the first 3 points, but not the 4th! These issues are dealt with below.

Socimer International Bank Ltd v Standard Bank London Ltd

Socimer concerned a discretion in the context of a positive obligation to value assets. The facts briefly were these. Socimer and Standard were international banks, which had been trading together in emerging markets securities. Standard was the 'seller' and Socimer the 'buyer'. Socimer was failing. It was put into default and owed Standard US$24.5million in what were called "Unpaid Amounts" in respect of a portfolio of forward sales of securities which it had bought. The 'termination date' was 20 February 1998. Under the agreement the "Standard Terms for Forward Sale Transactions" the creditor bank, the seller, had to "liquidate or retain" the buyer's portfolio (the "Designated Assets") to satisfy the amount that the buyer owed it. The important clause was Clause 14(a)(bb), which provided:

> "The value of any Designated Assets liquidated or retained and any losses, expenses or costs arising out of the termination or the sale of the Designated Assets shall be determined on the date of termination by Seller".

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7 [2008] 1 Lloyd's Rep 558.

Standard, the seller, did not in fact carry out a valuation under clause 14(a)(bb). Instead, it sold the parts of the portfolio that it could over months and years and credited the proceeds to the buyer "in dribs and drabs".[8]

Meanwhile a few weeks after the termination date, on 3 March 1998, Socimer went into liquidation. Socimer's liquidator brought proceedings arguing that Standard ought to have carried out the valuation at the termination date, and had it done so, Socimer would have had a surplus of US$13.8million. The trial judge, Cooke J held that:[9]

> "[O]n the proper construction of the Agreement, Standard was obliged to value the Designated Assets as at the date of termination of the Agreement for the purpose of clause 14(a) of the Agreement and to bring into account the value as assessed as a credit against the amounts payable to Standard"

Following Cooke J's decision, the parties were still unable to agree on what the valuation of the portfolio ought to have been, had Standard valued the assets as required. The parties' calculations were over US$14million apart. Valuation issues were then addressed in court before Gloster J. Socimer convinced Gloster J that Standard was bound to take reasonable care in finding the true market value of the portfolio. This approach to the discretion was argued as a matter of contractual implication or as a matter of equity by analogy with the duties of a mortgagee with a power of sale.

Standard appealed to the Court of Appeal. The issue relevant here was whether Standard's valuation obligation was to carry out reasonable, objective, valuation or only the honest, but otherwise subjective, valuation which Standard would have carried out if it had been aware of its contractual obligation to value. Rix LJ wrote the primary judgment, with whom Lloyd and Laws LLJ agreed. Lloyd LJ did add a few comments of his own.

Rix LJ spent some time methodically deconstructing the decisions of Cooke J and Gloster J. He further criticised Socimer's senior counsel for failing to plead the implied term argument about the limitation on the discretion, and for asking the court to disbelieve witnesses, whom he failed to cross-examine, merely because their evidence supported an approach different to his client's.[10]

The Court of Appeal held that the discretion to value had to be exercised in good faith, that is, honestly. This overturned the decision of Gloster J below who had required a reasonable

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8 [2008] 1 Lloyd's Rep 558 at 560 per Rix LJ.

9 [2004] EWHC 1041 (Comm), quoted at [2008] 1 Lloyd's Rep 558 at 560 per Rix LJ.

10 [2008] 1 Lloyd's Rep 558 at 582, para [90].

valuation of the assets. In the context of this, Rix LJ stated: "In my judgment, the requirements of good faith and rationality are a sufficient protection. The danger to be guarded against… is abuse caused by self-interest. That is precisely what implicit good faith deals with. Commercial contracts assume such good faith, which is why express language requiring it is so rare." [11]

What is this idea of 'implicit good faith'?

Implicit Good Faith

In my view, Rix LJ is correct that good faith is "implicit" in contract law. While there might be a suggestion that the word 'implicit' merely means 'implied' and therefore requires an implied term, that does not do justice to the context of Rix LJ's use of that word. He speaks of "assumed good faith", which is more consistent with the idea that his meaning of "implicit" was "naturally or necessarily involved in, or capable of being inferred from, something else"[12]. Thus, Rix LJ was referring to a concept of inherent good faith or honesty, which is the default standard of behaviour for contracting parties. Legal concepts that are applicable to all contracts are not achieved by implied terms, but rather through construction, as is discussed below.

Good faith can be seen in two facets of contract law. First, and on a very general level, every aspect of contract law is, or should be, consistent with good faith because good faith is the essence of contract. Secondly, good faith is seen in construction of contract and in defining the 'default standard' of behaviour required, which is where the implied term of good faith is said to operate. That 'default standard' of good faith should be seen as requiring honest adherence to the bargain.

Recent Australian cases unfortunately fail to acknowledge the good faith element of contract rules, the first aspect.[13] Elsewhere, Professor Carter and I have provided illustrations of how we see

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11 [2008] 1 Lloyd's Rep 558 at 588. Finn J has also expressed the view that there is a implied universal duty of good faith. For example, in *Hughes Aircraft Systems International v Airservices Australia* (1997) 76 FCR 151 at 192-193 he stated "… I consider a virtue of the implied duty to be that it expresses in a generalisation of universal application, the standard of conduct to which all contracting parties are to be expected to adhere throughout the lives of their contracts". Finn J's method of incorporation of this 'universal duty' is as an implied term. See also *Esso Australia Resources Pty Ltd v Southern Pacific Petroleum NL* [2005] VSCA 228 at para [4] per Warren CJ.

12 *The Oxford English Dictionary*, 2008.

13 For example, in *Insight Oceania Pty Ltd v Philips Electronics Australia Ltd* [2008] NSWSC 710, at paras [168]ff Bergin J's reasoning appears to be that 'implicit' good faith would not always accord with the parties' intentions and for that reason a term of good faith should be implied when necessary, as a term implied in fact. However, her Honour also states that "good faith seems to me to subsume the obligation to act honestly" at

that contract law is underpinned with good faith.[14] We have pointed out that it is possible to find the operation of 'implicit' good faith in all aspects of contract law. Fundamentally, good faith will also be seen in construction of contracts. Principles of what is known as 'commercial construction' ensure that effect is given to the intentions of the parties, and generally ensures that good faith considerations are given effect. This leads to the issue of the implied term of good faith.

In most Australian cases an implied term of good faith and reasonableness has been implied as an 'extra'. If good faith is implicit or inherent, then generally there would be no need for any good faith term to be implied. This may seem like a purely academic disagreement with methodology. Yet if courts take the view that good faith must be incorporated by an implied term, it provides some explanation as to why 'good faith' has been given a content more onerous than appropriate or necessary, and is arguably inconsistent with the modern operation of contract law.[15] If it is accepted that good faith is implicit, and will operate at the stage of construction of contracts to set a default standard of honesty, then it is not immediately obvious why good faith should *also* be incorporated as an implied term. Such implication only seems to be occurring where courts have decided that a discretion or termination right should not be allowed to be exercised without some control and where there is no acknowledgement of the implicit or inherent operation of good faith. These issues are now considered.

Implied fetters on discretions and powers and the meaning of 'good faith'

In *Socimer*, Rix LJ considered the existing English authority on the issue of the limitations that are placed on a party's contractual discretion to make decisions, including *Abu Dhabi National Tanker Co v Product Star Shipping Ltd (The "Product Star") (No 2)*,[16] *Ludgate Insurance Co Ltd v*

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para [178]. With respect, if good faith merely requires honesty – which seems correct - then her Honour is at cross-purposes. The obligation to behave honestly cannot be excluded, just as fraud cannot be excused by agreement. An implied term is then *only* necessary if it imposes more than honesty and extends to reasonableness, which would rarely correspond with commercial parties' intentions, as Rix LJ states. Bergin J's decision was upheld on appeal (not discussing this issue): [2009] NSWCA 119.

14 JW Carter and Elisabeth Peden, "Good Faith in the Australian Contract Law" (2003) 19 *JCL* 155; "A Good Faith Perspective on Liquidated Damages" (2007) 23 *JCL* 157.

15 See eg *Royal Botanic Gardens and Domain Trust v South Sydney City Council* (2002) 186 ALR 289 at 311-12 per Kirby J.

16 [1993] 1 Lloyd's Rep 397.

Citibank NA,[17] *Gan Insurance Co Ltd v Tai Ping Insurance Co Ltd (No 3)*[18] and *Paragon Finance plc v Nash*.[19] He concluded:[20]

> "It is plain from these authorities that a decision maker's discretion will be limited, as a matter of necessary implication, by concepts of honesty, good faith, and genuineness, and the need for the absence of arbitrariness, capriciousness, perversity and irrationality. The concern is that the discretion should not be abused. Reasonableness and unreasonableness are also concepts deployed in this context, but only in a sense analogous to *Wednesbury* unreasonableness, not in the sense in which that expression is used when speaking of the duty to take reasonable care, or when otherwise deploying entirely objective criteria."

Rix LJ was critical of the approach taken by the first instance judge, Gloster J. She had concluded that "Standard was obliged to act honestly and reasonably and to arrive at a value which properly reflected the actual value of the Designated Assets as at the termination date".[21] She went on: "I do not view the obligation to act reasonably as anything in essence different from the obligation to use good faith: it is part of the good faith obligation that Standard should conduct the valuation process in a reasonable manner, to arrive at what objectively can be said to [be] a proper value of the Designated Assets at the termination date…"[22]

This approach is very similar to that expressed by Australian courts when dealing with implied terms of good faith, where generally no distinction is drawn between good faith and reasonableness.[23] By comparison, Rix LJ stated that the reference to objective standards "plainly" go beyond concepts of good faith and rationality.[24]

Gloster J suggested during argument in court that there was perhaps a comparison to be made between Standard's obligation to value and a mortgagee's powers of sale, where in England, reasonable care must be exercised. Socimer's lawyers took up this suggestion and argued that Standard's discretion to value the assets was in a similar situation. This was rejected by the Court of Appeal on the basis that the analogy was not appropriate. Lloyd LJ concentrated on this point alone

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17 [1998] Lloyd's Rep IR 221.

18 [2002] Lloyd's Rep IR 612.

19 [2002] 1 WLR 685.

20 [2008] I Lloyd's Rep 558 at 577.

21 Quoted at [2008] 1 Lloyd's Rep 558 at 578 (para 73), at para (36) of her judgment.

22 Quoted at [2008] 1 Lloyd's Rep 558 at 578 (para 73), at para (40) of her judgment.

23 See cases cited at footnote 1.

24 [2008] 1 Lloyd's Rep 558 at 578 (para 74).

in his speech, in which he otherwise agreed with Rix LJ.[25] His view was that mortgagees have powers and obligations imposed by the law of mortgages. He compared a situation *not* involving a mortgage, where it is only possible to incorporate similar type obligations if the tests for implication of terms are satisfied. He was not convinced that the tests could be satisfied in the case and therefore agreed with Rix LJ. He states:[26]

> "It seems to me … that [Gloster J] was led by that similarity into drawing, and applying, an analogy with mortgage law, while overlooking, on the one hand, the need to justify the implication on the basis of conventional contract law and, on the other hand the fact that, in relation to a mortgage, the duties by reference to which she drew the analogy do not derive, and cannot be derived, from such a process of implication, but are imposed as a matter of general law, which does not apply in the present case because the transaction is not a mortgage."

Again, this position can be contrasted with that in Australia, where it is well established that good faith has a role to play where a mortgagee has a power of sale. However, the meaning of 'good faith' in that context is not settled,[27] yet it does not require reasonable behaviour. Thus, in Australia while a mortgagee is not required to act reasonably when dealing with another's property, an innocent party will be required to exercise express rights to terminate reasonably, as evidenced by the decision in *Renard Constructions (ME) Pty Ltd v Minister for Public Works*,[28] which will be considered below. The opposite is the position in England, as evidenced by *Socimer*.

Finally, the method of incorporation of restrictions of good faith should be considered. Currently, the approach being taken in England and Australia is to imply a term when 'good faith performance' is required.

Implied Terms of Good Faith

Given that good faith as a concept or requirement underlies contract law and the recent statement of Rix LJ about "implicit good faith" setting a default standard of honesty and rationality, it must be

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25 [2008] 1 Lloyd's Rep 558 at 594.

26 [2008] 1 Lloyds' Rep 558 at 594.

27 See, eg *Quennell v Maltby* [1979] 1 WLR 318; *National Australia Bank Ltd v Sproule* (1989) 17 NSWLR 505 at 510; *Service Station Association Ltd v Berg Bennett & Associates Pty Ltd* (1993) 45 FCR 84; 117 ALR 393 at 401 per Gummow J.

28 (1992) 26 NSWLR 234. ('*Renard*').

asked whether we need an implied term of good faith? Yet *Socimer* and *Renard* both proceeded on the basis of incorporating good faith with an implied term.[29] Courts (especially in New South Wales) seem to prefer the idea that the term requiring good faith and reasonableness should be regarded as one implied in law.[30] In England, while the meaning attributed to 'good faith' is the more defensible one of 'honesty', there is a preference for using a term implied in fact, as evidenced by *Socimer*.[31]

The 'implied term approach' is misconceived. As good faith is already implicit in contract rules and construction principles, if a court implies a term of good faith the court is either implying a redundant term or implying a term which imposes a more onerous obligation. In some cases it *might* be appropriate to incorporate a requirement of a higher standard of behaviour than the law otherwise requires, but such a term must either be incorporated as a matter of construction or satisfy the rules for implication, which would be possible, but unusual. In relation to the cases which suggest a term of good faith is implied in law, the problems are that:

(a) terms implied in law create default rules, and as good faith is already the default position, this adds nothing more; and

(b) terms implied in law are incorporated as default rules for contracts dealing with particular relationships, rather than all contracts, and therefore the implied term approach cannot be appropriate to incorporate good faith into every contract.[32]

Furthermore, using an implied term approach seems a 'backwards' step. A comparison can be made with other aspects of law that developed from an implied term approach, but moved away from that

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29 See Elisabeth Peden, 'Incorporating Terms of Good Faith in Contract Law in Australia' (2001) 23 *Syd LR* 222; Elisabeth Peden, *Good Faith in the Performance of Contracts*, Butterworths, Sydney, 2003, paras 6.10-6.19.

30 See, NSW Court of Appeal decisions, such as *Burger King v Hungry Jack's Pty Ltd* [2001] NSWCA 187, at [164]; *Alcatel Australia Ltd v Scarcella* (1998) 44 NSWLR 349 at 369 per Sheller JA (with whom Powell and Beazley JJA agreed). Cf *Renard* (1992) 26 NSWLR 234 at 263 (where Priestley JA seemed to conceive of a 'hybrid' term); *Vodafone Pacific Ltd v Mobile Innovations Ltd* [2004] NSWCA 15. In *CGU Workers Compensation (NSW) Ltd (ACN 003 181 002) v Garcia* (2007) 69 NSWLR 680 in the context of insurance, the NSW Court of Appeal did state that the law has not yet gone so far as to imply a term requiring good faith performance into all contracts, but did leave open that possibility (at paras 131-136). The Court did not clarify the issue of the meaning of good faith and whether it includes reasonableness. First instances judges take differing approaches. For example, Einstein J prefers a term implied in law: see eg *PRP Diagnostic Imaging Pty Ltd v Pittwater Radiology Pty Ltd* [2008] NSWSC 701 at paras 99-104. Compare Bergin J in *Insight Oceania Pty Ltd v Philips Electronics Australia Ltd* [2008] NSWSC 710, at para [177] who preferred a term implied in fact.

31 *Socimer International Bank Ltd v Standard Bank Ltd* [2008] 1 Lloyd's Rep 558.

32 See generally Peden, *Good Faith in the Performance of Contracts*, 2003, chapter 6.

approach when it was acknowledged that such an approach was ‘fictitious’. Anticipatory repudiation and frustration are examples.[33] Courts should feel confident enough to recognize implicit good faith, without recourse to implied terms.

The problem of this approach is tied up with the meaning that is being given to ‘good faith’. If courts are implying a term of ‘good faith’ which requires objectively reasonable behaviour, as did Gloster J in *Socimer* and many Australian cases appear to do, then the courts are actually using good faith as a rationale for a specific implication that a party act reasonably when exercising an express right of termination or discretion to value. Of course, that specific implication would be difficult to reconcile with authority,[34] and the attraction of the language of ‘good faith’ is that it enables a judge to reach a result that authority might not otherwise permit.

In *Socimer*, the argument in favour of an implied term fettering the exercise of the discretion was that while Standard could be trusted to act in its own interest to get the best price when selling designated assets, this was not necessarily the case when valuing a retained asset. In that situation, Standard’s interest was in conflict with the interests of the buyer, Socimer, because it would want to assign as low a value as possible so as to maximize potential profit on a later sale.[35] Gloster J held there should be an implied term that “imposes on Standard a duty, in doing its valuation, to take reasonable precautions to value the Designated Assets at ‘the fair’ or ‘the true market’ or ‘proper’ value”.[36]

While Rix LJ disagreed and held that the fetter was merely to behave honestly, it is interesting that he agreed that the fetter ought to be incorporated by implication of a term.[37] He highlighted the “useful and authoritative modern restatement of the relevant principles upon which

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33 See eg in relation to frustration *Denny, Mott & Dickson Ltd v James B Fraser & Co Ltd* [1944] AC 265; *Davis Contractors v Fareham UDC* [1956] AC 696; *Codelfa Construction Pty Ltd v State Rail Authority of NSW* (1982) 149 CLR 337. In relation to anticipatory breach see M Mustill, *Anticipatory Breach*, Butterworths Lectures (1989-1990), p53; JW Carter, *Breach of Contract*, 2nd ed, 1991, paras 717-26. See also Elisabeth Peden, *Good Faith in the Performance of Contracts*, 2003, paras [2.7]-[2.12].

34 See eg *Tanwar Enterprises Pty Ltd v Cauchi* (2003) 201 ALR 399, where exercise of a right of termination for breach of an essential time clause was upheld as there was no unconscientious behaviour (and reasonableness was not considered); *Meehan v Jones* (1982) 149 CLR 571, where the High Court did not require reasonable behaviour of a purchaser given a discretion to find satisfactory finance; *White and Carter (Councils) Ltd v McGregor* [1962] AC 413, where the House of Lords did not require an innocent party to behave reasonably in deciding whether to exercise a common law right to terminate.

35 [2008] 1 Lloyd’s Rep 558 at 583, para [96].

36 Quoted at [2008] 1 Lloyd’s Rep 558 at 578-9, paras [74]-[75].

37 At [2008] 1 Lloyd’s Rep 558 at 587, para [111], Rix LJ points out that the implied terms contended for by the parties were different.

terms may be implied"[38] of *Philips Electronique Grand Public SA v British Sky Broadcasting Ltd*,[39] which relied upon *BP Refinery (Westernport) Pty Ltd v Shire of Hastings*,[40] and the '5 point test',[41] which has been repeated in High Court decisions many times and is the standard authority for implication in fact in Australia.

Rix LJ states:[42]

> "The courts' usual role in contractual interpretation is, by resolving ambiguities or reconciling apparent inconsistencies, to attribute the true meaning to the language in which the parties themselves have expressed their contract. The implication of contract terms involves a different and altogether more ambitious undertaking: the interpolation of terms to deal with matters for which, ex hypothesi, the parties themselves have made no provision. It is because the implication of terms is potentially so intrusive that the law imposes strict constraints on the exercise of this extraordinary power."

In relation to the implication of fetters on discretion he adds:[43]

> "Implications of good faith and rationality, and lack of arbitrariness or perversity, are standard, for they represent the very essence of business (and other) relationships. Once one goes beyond them, however, the matter becomes much more uncertain."
>
> "In my judgment, the requirements of good faith and rationality are a sufficient protection. The danger to be guarded against… is abuse caused by self-interest. That is precisely what implicit good faith deals with. Commercial contracts assume such good faith, which is why express language requiring it is so rare."[44]

Having stated the law this way, it is not clear why then Rix LJ felt that the fetter on the exercise of the discretion needed to be achieved by an implied term. He had concluded that express terms requiring good faith were usually unnecessary in commercial contracts and that strict constraints are placed on courts wishing to imply terms. Furthermore, he applied the test of whether it was 'necessary' to imply a term requiring reasonable behaviour, and decided that the test could not be

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38 [2008] 1 Lloyd's Rep 558 at 585.

39 [1995] EMLR 472.

40 (1977) 52 ALJR 20; (1977) 180 CLR 266.

41 "[F]or a term to be implied, the following conditions (which may overlap) must be satisfied: (1) it must be reasonable and equitable; (2) It must be necessary to give business efficacy to the contract, so that no term will be implied if the contract is effective without it; (3) it must be so obvious it goes without saying; (4) it must be capable of clear expression; (5) it must not contradict any express term of the contract".

42 [2008] 1 Lloyd's Rep 558 at 585.

43 [2008] 1 Lloyd's Rep 558 at 586.

44 [2008] 1 Lloyd's Rep 558 at 588.

satisfied, as the term was not necessary. In his view, it ran against "the vein of the agreement as a whole, which plainly gave the determination of value to Standard, in the exercise of its subjective judgment and subject to a wide discretion."[45] Nevertheless, he decided that a term could be implied in fact that the discretion be exercised in good faith, that is requiring rationality etc, but without going through the same application of the test for implication in fact.

Might it not have been possible to conclude that as the "vein of the agreement" only required good faith? That is, might it be said that Socimer's obligation to exercise the discretion to value in good faith was achieved through construction? Would that not have been, in Rix LJ's language, attributing "the true meaning to the language in which the parties themselves have expressed their contract"?[46]

With that in mind, what is the state of the law in Australia? In Australia, since the decision of *Renard* in 1992, there has been judicial support for the idea that rights of termination ought to be fettered with an implied term requiring good faith and reasonableness. The method of incorporation of the fetter is the same as that used in England, namely an implied term, yet the fetter is generally a more onerous obligation of objective reasonableness, rather than subjective honesty.

Renard Constructions (ME) Pty Ltd v Minister for Public Works

In contrast to the decision in *Socimer*, is the NSW Court of Appeal decision in *Renard*, which has led to numerous decisions implying terms of good faith and reasonableness. In *Renard* the ability of the principal under a building contract to rely on a show cause procedure was subjected by the NSW Court of Appeal to requirements of reasonableness. Priestley JA said:[47]

> The contract can in my opinion only be effective as a workable business document under which the promises of each party to the other may be fulfilled, if the subclause is read in the way I have indicated, that is, as subject to requirements of reasonableness.

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45 [2008] 1 Lloyd's Rep 558 at 583, para [94].

46 Compare *Boat Park Ltd v Hutchinson* [1999] 2 NZLR 74 where the meaning and standard of a 'valuation' was determined by construction of the clause. At 83-4, Thomas J (on behalf of the Court of Appeal) stated: "by 'valuation' something that is recognizable as a bona fide commercial attempt to value the property is contemplated. We accept that it must be prepared in good faith. But more is required. In our view the valuation contemplated by the clause must be a proper valuation in the sense that it has been prepared by a registered valuer in accordance with basic valuation principles and basic valuation methods".

47 (1992) 26 NSWLR 234 at 258.

This requirement of reasonableness now seems to be regarded as a main ingredient of good faith in Australian cases.[48]

In *Renard*, the issue was the operation of cl 44.1 of the contract. This clause provided that if the contractor defaulted the principal was entitled to call upon the contractor, by notice in writing, to 'show cause within a period specified in the notice' why the powers set out in the clause 'should not be exercised'. Clause 44.1 required:

- Written notice;
- The notice to state it was a notice under the clause; and
- The notice to specify the default.

Had these requirements not been express, arguably good faith and commercial construction would have required the principal to provide this information to the contractor in any event. Factually, there was no need to incorporate reasonableness, as the principal had acted contrary to good faith, that is, it had failed to act honestly.

The clause further provided that if the contractor failed to show cause to the satisfaction of the principal within the time given, then the principal could take over the work or cancel the contract. The contractor did not complete the work on time, and the principal served a notice under cl 44.1. While the contractor was clearly in default, the delay was in part because the principal had not provided the contractor with necessary materials as required. The principal then purported to terminate the contract. The arbitrator found that this decision was based on "unfairly misleading, incomplete and prejudicial information".[49]

The majority of the Court of Appeal, Handley and Priestley JJA, implied a term in fact or in law, (or in what Priestley JA called a 'hybrid' of the two[50]) that the principal act in good faith and reasonably. They also held that this term had been breached by the purported termination in the circumstances. Meagher JA, on the other hand, by construing clause 44.1 found it required the principal to act on accurate information when forming a view on whether the contractor had shown

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48 See eg *Burger King Corp v Hungry Jack's Pty Ltd* [2001] NSWCA 187, reported in part (2008) 69 NSWLR 558 and cases following. See however *Hunter Valley Skydiving Centre Pty Ltd v Central Coast Aero Club Ltd* [2008] NSWSC 539 at [48].

49 (1992) 26 NSWLR 234 at 246.

50 (1992) 26 NSWLR 234 at 263.

cause. This had not occurred, and therefore the principal's purported termination was wrongful. In other words, it might be said that 'implicit' good faith required an honest use of clause 44.1.

Such implicit good faith has already been recognised by the Australian High Court for some time, but perhaps forgotten. In 1953 in *Carr v J A Berriman Pty Ltd,*[51] the High Court resorted to construction and implicit good faith, without expressly referring to them, to resolve a dispute about the operation of a contractual discretion. The relevant clause entitled an architect to use his 'absolute discretion' to omit work from a building. The principal argued that this clause entitled it to omit steel fabrication work from the contract for the purpose of having the work done by a third party (presumably more cheaply). Fullagar J acknowledged that such a clause was common and had an obvious purpose of enabling the architect to manage the construction of the building as appropriate. However, he stated:[52]

> But [the words] do not, in my opinion, authorize him to say that particular items so included shall be carried out not by the builder with whom the contract is made but by some other builder or contractor. The words used do not, in their natural meaning, extend so far, and a power in the architect to hand over at will any part of the contract to another contractor would be a most unreasonable power, which very clear words would be required to confer.

Two points might be made from Fullagar J's judgment in *Carr v Berriman*. First, he was adopting what might be called a 'good faith interpretation', just as Meagher JA did in *Renard*. In both cases interpretation was enough to determine whether the principal or architect was entitled to act in the way it had acted on the particular facts. The principal's argument in *Renard* was for what Fullagar J described as "a most unreasonable power", because it would have allowed the principal to decide that cause had not been shown without considering accurate information.

Secondly, in *Carr v Berriman* there was no recourse to implied terms to reach the result. The same might have been true in *Renard* and *Socimer*. However, the current approach taken in Australia and England appears to be a preference to incorporate good faith through an implied term. The difference between the approaches on either side of the globe is that the term being implied in England only requires honesty, and not reasonableness.

While the result in *Renard* is not problematic, the subsequent cases in which it has been applied have led Australian contract law into a peculiar situation. Commercial parties are now faced

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51 (1953) 89 CLR 327.

52 (1953) 89 CLR 327 at 347. The other members of the High Court agreed.

with the question of whether they dare to suggest in negotiations that they are not prepared to perform 'in good faith' as that may require reasonableness on their part. Alternatively, should they expressly state that they will not behave reasonably, or will that be a 'deal breaker'? Arguably this was not an issue before *Renard*, as in the words of Rix LJ, "commercial contracts assume good faith". It is only now with the uncertainty that has arisen from *Renard* that contracting parties are left with the additional negotiation and drafting problem, and possibly litigation.

It might be noted that there are two recent first instance decisions in New South Wales that question the validity of implying a term of good faith into contracts. In *Hunter Valley Skydiving Centre Pty Ltd v Central Coast Aero Club Ltd*[53] Brereton J states that "the implication of a term that a contractual right will be exercised only in good faith does not fit neatly into the structure of Australian contract law".[54] In *Agricultural & Rural Finance Pty Ltd v Atkinson*,[55] Young CJ expressed the view that there had only been a "flirting" by courts with the idea of implying terms of good faith, an idea which he rejected in the case before him. So, while such decisions provide some hope, they are far outweighed by the number of decisions that take the '*Renard* approach'.

Standards of performance

Generally we think of contract obligations as 'strict'. Thus, a seller's obligation to deliver goods is strict and the goods must be delivered. It is not an excuse that they behaved honestly or reasonably; the obligation is to deliver or they are in breach. However, sometimes the strict obligation to do some positive act must be understood in the context of what is being done and where there is a discretionary element. Then the obligation requires only good faith or honest behaviour. For example, if the contract does not specify *when* delivery is due, then the Court will require delivery 'in a reasonable time' and consider the facts as to whether that time frame was complied with or not. Or if there is an obligation to value, the method of valuation will be considered and require honest valuation. Similarly, in *Socimer*, there was an obligation to value the assets. That obligation was strict; Socimer was obliged to value the assets at the termination date. But there was still a

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53 [2008] NSWSC 539.

54 [2008] NSWSC 539 at [48].

55 [2006] NSWSC 202, reversed on other grounds: *Gardiner v Agricultural & Rural Finance Pty Ltd* [2007] NSWCA 235.

question of 'how' the valuation should have been carried out. The Court of Appeal held that it only had to be carried out honestly, not reasonably.

This approach is consistent with other contexts where powers or discretions have been construed to require good faith performance. Examples are provided in the Court of Appeal decision and include for example, *Paragon Finance Plc v Staunton; Paragon Finance Plc v Nash*,[56] where there was a discretion to change interest rates, which was similarly found by the Court of Appeal to require the party provided with the discretion to behave in good faith, or not arbitrarily, capriciously or 'unreasonably' in the sense of *Wednesbury* unreasonableness. The other 'obvious' context where a strict obligation is not required is in contracts to provide professional services. For example, an accountant is expected to exercise reasonable care in provision of his or her accountancy services.

The interesting feature in these cases is the method of incorporation of the standard of behaviour required. In both situations dealing with powers and discretions and situations importing standards of care, the courts use the method of implied terms. However, in the former, terms implied in fact are preferred, whereas in the latter, terms are implied in law. Why is there a distinction, and is it valid?

In relation to standards of care incorporated into professional contracts, courts have used the mechanism of terms implied in law, as it has been understood that this obligation is part of the nature of the particular relationship involved in the contract. In Byrne v Australian Airlines Ltd, McHugh and Gummow JJ explained:[57] "Many of the terms now said to be implied by law in various categories of case reflect the concern of the courts that, unless such a term be implied, the enjoyment of the rights conferred by the contract would or could be rendered nugatory, worthless or, perhaps, be seriously undermined".

However, there are other possible ways to view this current, and inherently appropriate, situation where the obligation is not a strict one. For example, it is possible to view the question as one of construction of the scope of the obligation itself. That is, the professional does not promise to

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56 [2002] 2 All ER 248. See also *Abu Dhabi National Tanker Co v Product Star Shipping Ltd (The "Product Star") (No 2)* [1993] 1 Lloyd's Rep 397. See also *Equitable Life v Hyman* [2000] 3 All ER 961; *Gan Insurance Co Ltd v Tai Ping Insurance Co Ltd (No 2)* [2001] 2 All ER (Comm) 299.

57 (1995) 185 CLR 410 at 450.

do any more than provide reasonable care in the provision of the services. Alternatively, it could be seen as a situation where the presumed position of a requirement of good faith or honesty has been displaced because of the nature of the contract and been replaced with a standard of reasonable care.

The standard of performance ought always be recognised as a question of construction. For example, in *Greaves & Co (Contractors) Ltd v Baynham Meikle & Partners*[58] structural engineers were engaged to design the structure of a factory, including the first floor which was to cope with the weight of forklift trucks. The English Court of Appeal held that while courts will imply a term in law into contracts with professionals that they exercise reasonable care and skill, on the particular facts of the contract, the "evidence shows that both parties were of one mind on the matter. Their common intention was that the engineer should design a warehouse that would be fit for the purpose for which it was required", and therefore such a term was implied as a matter of fact.

Approaching the standard of obligation as a question of construction is consistent with the theory that good faith underlies the institution of contract law, and yet allows freedom of contract and the parties to provide for alternative standards through express terms. Further, construction of the contract provides more appropriate standards when a good faith or honest requirement is insufficient in the particular context.

Relationship between Construction and Implication

It is therefore important to consider the 'reach' of construction in the context of implication. Construction cannot create new obligations outside the contract itself. For example, if a contract provides that X must do A, B and C, in construing that contract the court can explain what A, B and C mean, or explain the 'spirit' of these terms. Often in doing so the courts decide there is a gap, and then proceed to imply a term. If a term is implied, the court would then theoretically have to construe that term to determine its meaning and application. So there is understandably some circularity or overlap between construction and implication which can confuse the issues.[59] Another problem is that many judgments do not explain their reasoning process, which makes it difficult to

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58 [1975] 1 WLR 1095 at 1100-1 per Lord Denning MR, with whom Browne and Geoffrey Lane LJJ agreed.

59 See eg Lewison, *The Interpretation of Contracts*, 4th ed, 2007, p196, for example, notes "It may be questioned whether the determination whether any and if so what terms are to be implied into a contract is truly part of the process of construing contracts at all."

determine what has occurred.[60] It is possible that construction plays a further role in implication and that construction can, in explaining the meaning of the contract, impose some obligation that did not exist on the face of the express terms. For example, where a contract is silent as to the effort required by one party to perform an express obligation, a court can by construction determine that in the context of the particular contract the obligation must only be performed with best efforts, rather than strictly.[61]

In many situations is it unclear from the terminology and approach taken whether the courts are using 'construction' or 'implication'. *Socimer* is one such example. *Socimer* has been approved and applied in *JML Direct Ltd v Freesat UK Ltd*,[62] where in discussing the fetters of good faith and rationality, Blackburne J emphasized the "need to approach the matter as one of *contractual implication* and to avoid importing expressions appropriate to public law challenges into the *construction* of a commercial contract".

A further example of this interrelationship between construction and implication is provided by the High Court of Australia's decision in *Secured Income Real Estate (Australia) Ltd v St Martins Investments Pty Ltd*,[63] which is a case often cited in the context of the 'good faith debate'. The case concerned the sale of a building, where the purchase price was to be determined by how much of it was rented. The question was whether the purchaser was obliged to rent part of it to the vendor in order for the vendor to receive a higher price. Mason J wrote the judgment of the court. At first suggested he suggested that the duty of co-operation arises as a matter of construction of the contract, stating "it is common ground that the contract imposed an implied obligation on each party to do all that was reasonably necessary to secure performance of the contract",[64] citing Blackburn LJ in *Mackay v Dick*. But when he continued, he seemed to suggest that it was a question of implication:[65]

> "It is not to be thought that this *rule of construction* is confined to the imposition of an obligation on one contracting party to co-operate in doing all that is necessary to be

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60 See eg JW Carter, "'Commercial' Construction and the *Canada SS* Rules" (1995) 9 *JCL* 69 at 74-5.

61 For example, courts must determine whether parties promised to use best endeavours to obtain licences or undertook absolutely that a licence would be obtained. Eg *Re Anglo-Russian Merchant Traders Ltd and John Batt & Co (London) Ltd* [1917] 2 KB 679; *Brauer & Co (Great Britain) Ltd v James Clark (Brush Materials) Ltd* [1952] 2 All ER 497; *Malik Co v Central European Trading Agency Ltd* [1974] 2 Lloyd's Rep 279.

62 [2009] EWHC 616 (Ch) at paragraph [43].

63 (1979) 144 CLR 596.

64 (1979) 144 CLR 596 at 607.

65 (1979) 144 CLR 596 at 607-8. (emphasis added).

> done for the performance by the other party of his obligations under the contract. As Griffith CJ said in *Butt v M'Donald*:[66]
>
> > 'It is a general rule applicable to every contract that each party agrees, by implication, to do all such things as are necessary on his part to enable the other party to have the benefit of the contract.'
>
> It is easy to imply a duty to co-operate in the doing of acts which are necessary to the performance by the parties or by one of the parties of fundamental obligations under the contract. It is not quite so easy to make the implication when the acts in question are necessary to entitle the other contracting party to a benefit under the contract but are not essential to the performance of that party's obligations and are not fundamental to the contract. Then the question arises whether the contract *imposes* a duty to co-operate on the first party or whether it leaves him at liberty to decide for himself whether the acts shall be done, even if the consequence of his decision is to disentitle the other party to a benefit. In such a case, the correct *interpretation* of the contract depends... not so much on the application of the general *rule of construction* as on the *intention* of the parties as manifested by the contract itself."

The italicised words are a mixture of terminology used in, and appropriate to, construction of contracts and implication of terms, and it is not clear exactly which approach is being taken. The quotation from *Butt v M'Donald* states that the obligation to co-operate is implied, and Mason J adopted this terminology at the beginning of the next paragraph. But towards the end of it he again suggested that that it was a matter of construction.

Contracts are construed in accordance with the parties' intentions and the notion of upholding the bargain. However, 'duties' of co-operation are often implied terms that are necessarily implied, because the contract contains a gap that must be filled. Thus, Mason J was correct to state that it is easy to imply such a term where it is necessary for the working of the contract, but less easy where it is purely helpful to one party, since this would not satisfy the implied term test of necessity for 'business efficacy'. This approach has been endorsed by members of the High Court in *Byrne & Frew v Australian Airlines Ltd*,[67] where it was said that "the more modern and better view is that these rules of construction are not rules of law so much as terms implied, in the sense of attributed to the contractual intent of the parties, unless the contrary appears on a proper construction of their bargain."[68]

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66 (1896) 7 QLJ 68 at 70-71.

67 (1995) 185 CLR 410 at 447-453 per McHugh and Gummow JJ. The other judges did not comment on *Mackay v Dick*.

68 (1995) 185 CLR 410 at 449.

Construction has 'expanded' to replace implied terms in relation to the doctrines of frustration.[69] While it can be argued that construction might replace implication of terms,[70] this is not the accepted view at present.[71] However, in the recent Privy Council decision of *AG of Belize & Ors v Belize Telecom Ltd & Or,* Lord Hoffman, on behalf of the Privy Council, stated:[72] "implication of the term is not an addition to the instrument. It only spells out what the instrument means…. [T]he implication of a term is an exercise in the construction of the instrument…" In his view, "there is only one question: is that what the instrument, read as a whole against the relevant background, would reasonably be understood to mean?"[73]

Construction and implication are both limited to operate within the four corners of the contract, as defined by the parties. Implication fills in missing pieces in that jigsaw, while construction gives the appropriate colour or shading to pieces that already exist to provide the picture with a realistic and workable look. For example, if there was a contract that X should go to Brisbane to deliver goods in return for money from Y, it is possible that both construction and implication would have a role. First, the term that X should go to Brisbane could be construed to determine if it was a condition or a warranty. This is not the job of implication. Then, if it were in issue, the courts might be asked whether it was part of the contract that X would deliver the goods before Wednesday 2nd. One argument would be that there might be an implied term that X would deliver the goods before Wednesday 2nd. This would require the application of the tests of implication in fact to determine whether the parties intended that this should be a term.

However, why is it not the appropriate approach to determine the issue by construction? Although at first glance it appears a 'big jump' from the express term to this term, when other facts are considered the jump is not so big and at a doctrinal level we are simply interpreting the express terms, that is, construing them. Because the jump seems large we may say it is 'implication by construction', rather than a mere 'entailment' from the express terms. The term that X deliver the goods is express. To determine whether X should perform this task before Wednesday 2nd is merely

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69 *Davis Contractors Ltd v Fareham UDC* [1956] AC 696. See further, Peden, *Good Faith in the Performance of Contracts*, 2003, paras 2.7-2.9.

70 See eg Peden, *Good Faith in the Performance of Contracts*, 2003, Chapter 7.

71 See eg *Gordon and Gotch Asutralia Pty Ltd v Horwitz Publications Pty Ltd* [2008] NSWCA 257 at para [36].

72 [2009] UKPC10, at paragraphs [18]-[19].

73 [2009] UKPC10 at paragraph [21]. Lord Hoffman was concerned that "there are dangers in treating the [tests' for implication in fact] as different or additional tests": at paragraph [21].

to add colour or detail to that term. There is no gap concerning an obligation. There is no issue as to which party must deliver the goods. The only issue is when. How is this question to be determined? The court considers the sentence and its context in the contract. It may be merely a question of order of performance. For example, the contract might state that Y needs to use or deliver the goods to Z the same day or soon after, making it clear that X must deliver the goods on Wednesday 2nd. Order of performance is always considered an issue of construction, because it is based on intention.[74] Alternatively, the court might construe the term to mean that it must be performed within a 'reasonable time', which is discussed below.

Many examples might be given of situations where courts are prepared to incorporate 'inherent' obligations through construction, rather than resorting to an implied term.[75] Examples include the following:

(a) requirement to perform in a 'reasonable time', when no time is specified;

(b) deciding which party should perform obligations, where no party is specified;

(c) implying or construing detail into an otherwise silent contract.

(a) Reasonable time.[76]

Often terms without specified times for performance are deemed to include a reasonable time limit.[77]

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74 Generally Carter, Peden & Tolhurst, *Contract Law in Australia*, 5th ed, 2007, para 28-05. See also *Brooks v Burns Philp Trustee Co Ltd* (1969) 121 CLR 432 at 463-4 per Windeyer J; *Burton v Palmer* [1980] 2 NSWLR 878 at 895, that the intention of the parties in relation to order of performance is to be "derived by implication" from the terms of the contract and any admissible evidence of surrounding circumstances. "Implication from the terms" of the contract can be seen as equivalent to stating the implication is "implicit" or "inherent" rather than relying on an implied term.

75 See for example *Legal & General Assurance Society Ltd v Expeditors International (UK) Ltd* [2007] 2 P&CR10, where Lloyd LJ implied a term, and Sedley LJ approached the matter as one of construction.

76 Other terms of 'reasonableness' are implied by construction also. Eg *Finchbourne Ltd v Rodrigues* [1976] 3 All ER 581, where the Court of Appeal held that in a tenancy agreement where the managing agents were to certify the amount the tenant was to contribute to the maintenance of the flats, there was an implied term that the costs be fair and reasonable. This term was justified with the parties' intentions. The exercise of rights under contracts and discretions are construed to require reasonableness. For example, where a ship-master was entitled to land cargo at a different port for safety reasons, it was held that the master was "bound to exercise that discretion fairly as between both parties, and not merely to do his best for the shipowners, his masters, disregarding the interests of the charterers": *Tillmanns & Co v SS Knutsford Ltd* [1908] 2 KB 385 at 406 per Farwell LJ; affirmed [1908] AC 406.

77 Generally Lindgren, *Time in the Performance of Contracts*, 2nd ed, 1982, paras 451-453.

(b) Deciding which party should perform.

Courts can, as a matter of construction, determine that one party has an obligation to carry out a task that is necessary for the contract to operate, even though it is not expressly required in the contract. For example, in in *AV Pound & Co Ltd v MW Hardy & Co Inc*[78] the judges had to decide which party to a sale of goods contract (turpentine) had to obtain an exporters' licence.[79] The contract was illegal without a licence. The House of Lords held that as a matter of construction of the contract it was the sellers' duty to obtain the licence.[80] Viscount Kilmuir LC decided this because the sellers had all the information. Viscount Simonds held that there was no express obligation on the buyers to obtain the licence, and then considered whether it was implied by construction. He could find no such obligation "according to the ordinary principles of construction".[81] Therefore, the sellers' case failed.[82] There is no problem with the result. [83] The interesting point is the use of "construction".

Viscount Simonds did not explain which "ordinary principles of construction" he was using. Since there was no express term specifying which party should obtain the licence, which was vitally necessary for the completion of the contract, this specification needed to be implied. The judges construed the contract as a whole to determine the result. In effect, they decided that the contract expressly required the buyers to do A, B and C, and this did not impliedly include the obligation to obtain the licence.

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78 [1956] AC 588.

79 See Treitel, Frustration and Force Majeure, 2nd ed, 2004, para 8-012 suggests that where a contract is silent as to which party must obtain a licence the court decides by asking which party is in a better position to obtain the licence. As regards the standard of the duty to obtain a licence, he suggests that if the contract is silent as to the need for an export licence, generally a term will be implied requiring a party to use due diligence to obtain a licence. However, where there is an express term, the standard of the duty will be determined by construction of the whole contract: paras 8-011-2. Also *Benjamin's Sale of Goods*, 7th ed, 2006, paras 18-309ff.

80 For this reason there was no need to decide the issue of frustration. See Treitel, *Frustration and Force Majeure*, 2nd ed, 2004, paras 8-020-8-022.

81 [1956] AC 588 at 606.

82 Lord Morton agreed with Viscounts Kilmuir and Simonds. Lord Reid concurred. Lord Somervell agreed in a short speech.

83 Viscount Simonds went on to assume that the obligation was the sellers' and held that in such a case, the buyers would have to co-operate by telling the seller the destination of the goods and "otherwise as may be reasonable": [1956] AC 588 at 606. This suggests an open-ended obligation to co-operate. However, this obiter statement can be explained as an expression of willingness on the part of the court to imply terms embodying the notion of co-operation as required. See also *Peter Cassidy Seed Co Ltd v Osuustukkakauppa IL*[1957] 1 WLR 273.

Why was construction rather than the tests of implication the correct tool? Could it not be argued that there was a clear gap in the contract, since there was no term expressly stating which party should obtain the licence, and the only way that gap could be filled was by implication of a term? The reason that construction was the appropriate means of solving the problem is that obtaining the licence was not a completely new obligation that was not contained within the express terms. Exporting the goods involved the procuring of a licence. Therefore, it was merely the explanation of the contract, the construction of the contract that was needed to determine whether the buyers were obliged to obtain the licence. Admittedly, the decision could be clearer, and might have been, had the buyers been suing the sellers and had the court been required to determine whether the sellers needed to obtain the licence.

(c) Implying detail.

'Implication by construction' is not limited to determining which party should perform an obligation or when an obligation must be performed. Providing that express terms in the contract provide the substance of an answer to the problem, the courts can 'imply' the detail. Using the jigsaw analogy again, this would be where the colour and detail of the pieces surrounding a missing piece sufficiently explain what the missing piece looks like. An example is provided by *Television Broadcasters Ltd v Ashton's Nominees Pty Ltd*.[84] There, the parties were to promote a circus tour. The agreement specified which expenses would be paid by the plaintiff, and which by the defendant. After expenditure, profits were to be divided equally. The circus made a loss, and the question was whether there was an implied term that losses would be borne equally, or whether each party would be responsible for those losses incurred as a result of the express expenditure obligations. The trial judge applied the test of implication from Scrutton LJ in *Reigate*,[85] and *Heimann v Cth*[86] and concluded that both parties would not have included such a term and so none could be implied in fact.

However, the Full Supreme Court of South Australia took a different view. The Court held it must have been implied that the monies would be distributed rateably between the parties and it followed that any deficit would be split rateably between the parties in proportion to the amounts

84 (1979) 22 SASR 552.

85 [1918] 1 KB 592.

86 (1938) 28 SR (NSW) 691 at 695.

which they had agreed to spend in the contract.[87] The Court declared that "on the true construction of the agreements ... losses or expenditure should be shared or borne by the plaintiff and the defendant rateably" in proportion to their agreed expenditure. The Court did not refer to the tests of implication used by the trial judge. Instead, they thought it was clear as a matter of construction, based on intention that the parties, that they would split the losses.

The Court decided that the express provisions for the expenses and profits provided the skeleton of the answer required in the circumstances. It was possible to imply from construction of the agreement how losses would be divided.

Would an implied term have been an alternative solution? In all cases of 'implication by construction' there is no need to resort to the traditional test of implication of terms. The reason that implication proper is unnecessary is that the express terms already provide the answer. The court does not need to go further to question what the parties would have intended and whether business efficacy and obviousness require the implication of a term.

Another example is *Borys v Canadian Pacific Railway Co*[88] where the original owner of land had sold it, reserving the right to all coal, petroleum and valuable stone. The new owner refused to allow the original owner's assignee onto the land to take the petroleum. The Privy Council held that "inherently" the reservation of the substance necessarily implied the existence of a power to recover it and the right of working on the land. The express words of the contract contained the answer, and so there was no need to resort to implication tests.

Conclusion

Construction serves several purposes. Its most well-known function is to explain the legal meaning of the contract. This is important when implication is an issue, since it is by construction that the gaps in the contract are identified. It is also by construction that the parties' intentions are identified. However, construction can also be used to fill some gaps on its own. This process is sometimes

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87 (1979) 22 SASR 552 at 575.

88 [1953] AC 217. Compare a case like *Saner v Bilton* (1878) 7 ChD 815, where the lessor covenanted to keep the main walls in good repair. Fry J held at 824 that this carried an implied licence to enter the premises and occupy for a reasonable time to do what he had covenanted to do.

called ‘implication by construction’, but is in fact distinct from implication of terms with the traditional tests. Implication by construction is simply the interpretation of contract terms using the full range of what may be legitimately used logically and linguistically. One argument against using such a technique is that it lacks certainty and precision that is said to be provided by the tests used in implication proper. However, courts have stressed in relation to interpretation of contracts that a ‘commercial’ approach should be taken.[89] This suggests that when construction is used for implication, then there are already rules in place to guide courts - matrix of fact and law, common sense, commercial background, history, reasonable result, and purpose of contract. This use of construction to imply terms merely requires the courts to explain more fully what they are doing.

The construction approach is less artificial than using the implied term approach. Yet, in contexts where a ‘fetter’ or ‘standard’ is imposed, courts are imposing it as an implied term, both in England and Australia. However, it is not clear where the ‘gap’ in the contract is that needs to be filled. The obligation or discretion is express. The only issue is the standard, to which the obligation or discretion must be performed. If an implied term is incorporated it is not a promissory implied term with a distinct operation, but is rather ‘parasitic’, dependent on the primary express obligation. Generally, when courts are faced with issues about the operation of express terms they define their role in terms of construction. Therefore, when faced with an issue about the operation of an express term and the standard of performance required, the approach should be the same, that is, one of construction.

There are clear limitations on the implied term approach. First, implication of a term in fact would usually be difficult, as such a fetter will rarely be necessary for business efficacy, as the contract could work without it by either requiring strict performance, or allowing absolute subjective discretion. Courts have indicated that where it is not specified, the ‘default’ position is a requirement of good faith or honesty, as in *Socimer*. But had it been appropriate in the context of a particular contract for a court to construe the obligation as requiring ‘reasonable’ valuation, that would have been possible. An obvious situation where this would be expected would be where the party providing the valuation was a professional engaged to provide that standard of performance.

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[89] Courts prefer a construction that is “reasonable or sensible, and not unreasonable, absurd or inconvenient”: Carter, Peden & Tolhurst, *Contract Law in Australia*, 5th ed, 2007, para [12-01]; see also Peden & Carter, “Taking Stock: the High Court and Contract Construction” (2005) 21 *JCL* 172; Carter & Peden, “The ‘Natural Meaning’ of Contracts” (2005) 21 *JCL* 277.

Terms implied by law can also be seen as examples of construction instead. They are 'default' positions that are assumed to be the way the contract should operate unless the parties have expressly changed that position.

Courts seem to favour the notion of implying a term to fetter the exercise of the discretions on the basis of implication in fact, that is, the term is necessary for the business efficacy of the contract.[90] This approach seems artificial. It is difficult to conceive of why the contract does not operate effectively without a term fettering the exercise of the discretion. In fact, if the discretion was to be exercised in a way that was acceptable to both sides, no doubt the contract would operate easily and the matter would never come to court. The issue only arises because one party feels hardly done by when the other party exercises the power, which is not expressed to contain any fetter, in a way that does not suit them, or they claim is 'unfair'. The better approach would seem to be to use construction of the contract, and in particular of the discretion provided. The principle of good faith would inform this process and the issue of whether the discretion was fettered could be considered on the particular facts.

If the courts accepted that good faith underlies construction, then the discretions or powers could be construed as requiring an exercise of good faith, which would be given meaning in the particular context.[91] The standard of behaviour required by good faith would only be honesty, loyalty to the contract and a requirement to consider the interests of the other party. This would place contractual exercise of discretions in the same position as the general exercise of powers: they must be exercised for a 'proper purpose', within the meaning of the contract. This would remove the artificial reasoning concerning implied terms. This approach is really an adoption of what was

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90 See eg *Paragon Finance Plc v Staunton; Paragon Finance Plc v Nash* [2002] 2 All ER 248 at [42]; *Equitable Life Assurance Society v Hyman* [2000] 3 All ER 961 at 970-1 per Lord Steyn; *Gan Insurance Co Ltd v Tai Ping Insurance Co Ltd (No 2)*[2001] 2 All ER (Comm) 299. Contrast *In re Nicholas and Grant's Lease* (1923) 44 ALT 169, where Irvine CJ construed or "read into" the express right of a landlord to increase rent the word "reasonably".

91 See *Western Metals Resources Ltd v Murrin Murrin East Pty L*td [1999] WASC 257, where Templeman J construed a discretion to give consent to an assignment as requiring an obligation not to withhold consent unreasonably: [22] However, he does later talk in terms of implication on the basis of necessity at [33], [39], [40], [49ff].

proposed by Sheller JA in *Alcatel Australia Ltd v Scarcella*,[92] when referring to a 1973 statement by Barwick CJ in *Pierce Bell Sales Pty Ltd v Fraser*[93]:

> "If a contract confers power on a contracting party in terms wider than necessary for the protection of the legitimate interests of that party, the courts may interpret the power as not extending to the action proposed by the party in whom the power is vested or, alternatively, that the powers are being exercised in a capricious or arbitrary manner for an extraneous purpose, which is another was (sic) of saying the same thing. Thus a vendor may not be allowed to exercise a contractual power where it would be unconscionable in the circumstances to do so."

This approach uses construction of the contract and the particular power or discretion to determine the appropriate meaning, without drawing on implied terms and concepts of objective reasonableness. This ought to make the resort to an implied obligation of good faith and reasonableness superfluous.

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92 (1998) 44 NSWLR 349 at 368.

93 (1973) 130 CLR 575 at 587. McTiernan J agreed as did Gibbs J, adding some extra comments. This statement has been adopted in many courts including the NSW Court of Appeal in *Vodafone* [2004] NSWCA 15 at para [216].

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"Good faith in contracts in financial services"

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When I had the privilege of addressing this conference four years ago on the subject of "Good faith, commercial morality and the courts", on a panel with the Chief Justice, I began with what amounted to an apology for not being able to entertain the audience by disagreeing with him and largely I find myself in the same miserable position again vis-à-vis my fellow panellists.

I want to begin by summarising where I got to four years ago. I reminded myself of the judicial tools which might make issues about good faith superfluous. They included unconscionability, fiduciary obligations, estoppel, invalidation of penalty clauses and relief against forfeiture. I noted that Lord Mansfield's view[1] that good faith was a "governing principle" had found favour in the United States[2] but not in commonwealth jurisdictions and I suggested it was because of the vagueness of the proposition – too imprecise to be a means of determining disputes between commercial organisations who need to know where they stand. The English Courts had rejected the notion that they had a general equitable jurisdiction to grant relief to a contracting party on some unlimited and unfettered basis. Although recognising that a modicum of uncertainty can sometimes be a force for good in the law, I suggested that we feel instinctively more comfortable with terms like misleading, deceptive, dishonest and fraudulent rather than with the much vaguer notions of good faith or commercial morality which depend upon one's perspective and make predictability of

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1 *Carter v Boehm* (1766) 3 Burr 1905 at 1910; 97 ER 1162.
2 *Wigand v Bachmann-Bechtel Brewing Co* (1918) 118 NE 618 at 619.

adjudication uncertain. I did, however, conclude that unconscionability (or unconscientious behaviour) was not so problematic, being descriptive of more extreme, more recognisable conduct, just as fraudulence is.

Then, having looked briefly at developments in Australia since *Renard*[3] and *Burger King*,[4] I suggested, politely I hope, that the implication of implied terms of good faith and reasonableness were unnecessary and unhelpful; that the particular cases really turned on the construction of contractual terms. It would have been orthodox simply to ask: What power was given? Was it a power restricted by purpose? Objectively, was it intended only for use in particular circumstances or in a particular way? Appeals to good faith and reasonableness did not assist with the necessary analysis of what, objectively, the parties intended when they wrote the contract.

I suggested that what seemed to be at the bottom of it all was the idea that a party to a contract should not be disloyal to the promises he or she had made. But that simply led back to what the defendant actually promised to the plaintiff. If I promise to do something, is it not implied, as a matter of fact rather than as a matter of law, that I will not do something which is entirely inconsistent with my promise? I cited in support of this proposition Lord Blackburn in *Mackay v Dick*[5] and Dixon J in *Shepherd v Felt and Textiles of Australia Ltd*.[6]

By way of analogy, I referred to the well-known principle of property law that when someone grants a right in relation to their property, they are not permitted to do something which derogates from the grant which they have made – a principle which has been said to embody common honesty and fair dealing; a grantor having giving a thing with one hand is not to take away the means of enjoying it with the other, to quote the words of Bowen LJ in *Birmingham, Dudley and District Banking Co v Ross*.[7]

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3 *Renard Constructions (ME) Pty Ltd v Minister for Public Works* (1992) 26 NSWLR 234.
4 *Burger King Corp v Hungry Jack's Pty Ltd* [2001] NSWCA 187, reported in part (2008) 69 NSWLR 558.
5 (1881) 6 App Cas 251 at p 263.
6 (1931) 45 CLR 359 at p 378.
7 (1888) 38 Ch D 295 at p 313.

This analysis shows us an example of the longstanding general principle that the law will not permit you to subvert your promise. You do not need to invoke good faith in order to support the principle. It flows from the nature of the contractual promise or obligation. It is a matter of the commonsense of the law. Instead of reaching up on the shelf for an implied term of good faith, why not simply construe the contractual provision in the context of the contract as a whole? A court would surely examine the provision in issue having regard to that context and would naturally say that, for example, a power given for a particular purpose should not be used for some extraneous or collateral purpose or in a manner that objectively went beyond any possible reasonable use of the power. The court would ask itself whether the use of the power could have been within the reasonable contemplation of both parties when they made their contract. This is what the English Court of Appeal did in *Paragon Finance plc v Nash*,[8] a banking case about the fixing of a rate of interest by the lender. The Court approached the matter as a matter of construction of the loan agreement and decided that rates of interest must not be set dishonestly, or for an improper purpose, or capriciously or arbitrarily. It did this by implying a term of that limited kind in order to give effect to the reasonable expectations of the parties. But it was not prepared to go further and extend the implied term so that it covered an unreasonable use of the power to fix the rate. It said it was one thing to imply a term that a lender would not exercise its discretion in a way that no reasonable lender, acting reasonably, would do. It was unlikely that a lender who was acting in that way would not also be acting either dishonesty or for improper purpose. But it was quite another matter to imply a term that the lender would not impose unreasonable rates. So it was found not to be a breach of contract for the mortgagee to raise interest rates in order to overcome its serious financial difficulties.

I am glad to be able to say that I supported my argument on that occasion by reference to an article of Professor Carter and Dr Peden[9] who had contended that a commercial

[8] [2002] 1 WLR 685.
[9] "Good Faith in Australian Contract Law" (2003) 19 JCL 155.

construction of a contract will actually achieve a result which is consistent with an underlying requirement of good faith and that recourse to an implied term is therefore unnecessary.

I tried to put in my own language this approach, saying that when you interpret a contract – when you say whether some action is or is not authorised by its terms – you assume honest behaviour – that the contract does not contemplate action which is capricious or arbitrary or motivated by a desire to harm the other party by depriving it of the benefit of the contract. You assume, in other words, that the contract does not permit behaviour which is outside the range of behaviour which, from an objective standpoint, could have been expected when the contract was made.

Now how do things stand some four years later? In Australia, so far as I am able to determine, not too much has changed. Trial courts in New South Wales seem to be still following, or at least paying lip service, to *Renard*[10] and *Burger King*.[11] It seems that this has not given rise to any result which would not have occurred if good faith went unmentioned. No case has gone to the High Court, so that Bench has not had the opportunity to put the New South Wales Court of Appeal in its place, if it should wish to do so as it has rather firmly done on other subjects. In fact, the Court of Appeal has shown signs of pulling back in *CGU Workers Compensation (NSW) Ltd v Garcia*[12] and the Victorian Court of Appeal may have poured some cold water on the earlier New South Wales cases,[13] as Chief Justice de Jersey has noted.

In New Zealand, despite a conference[14] on good faith in contract law held in Auckland only about a month after your conference in Cairns and attended by many of the usual suspects, such as Justice Finn and the former New Zealand Court of Appeal Judge, Ted Thomas, the courts have been entirely silent on the subject.

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10 (1992) 26 NSWLR 234.

11 [2001] NSWCA 187.

12 (2007) 69 NSWLR 680 at paras [130] – [134].

13 *Esso Australia Resources Pty Ltd v Southern Pacific Petroleum N L* (2005) VSCA 228.

14 For published conference papers, see (2005) 11 NZBLQ at pp 367–503.

One English case of note of which I am aware, directly appearing to invoke good faith, is the *Socimer*[15] decision of the English Court of Appeal to which Dr Peden refers in her paper. It concerned what was required of a bank called upon by a contractual provision to determine the value of certain assets when an amount due to it had not been paid by the other party. In the leading judgment of Rix LJ, various earlier cases from the English Court of Appeal on the exercise of contractual powers are discussed. In *The "Product Star*",[16] for example, the Court had recognised the usefulness of an analogy with judicial control of administrative action but said it must be applied with caution to the assessment of whether a contractual discretion had been properly exercised. The essential question always was whether the relevant power had been abused. The Court said that the authorities show that not only must the discretion be exercised honestly and in good faith, but as well, having regard to the provisions of the contract by which it is conferred, it must not be exercised arbitrarily, capriciously, or unreasonably.[17] Little was added by the concept of fairness which did no more than describe the result achieved by the application of that approach.

Rix LJ drew from the authorities to which he referred that:[18]

> a decision maker's discretion will be limited, as a matter of necessary implication, by concepts of honesty, good faith, and genuineness, and the need for the absence of arbitrariness, capriciousness, perversity and irrationality. The concern is that the discretion should not be abused. Reasonableness and unreasonableness are also concepts deployed in this context, but only in a sense analogous to Wednesbury unreasonableness, not in the sense in which that expression is used when speaking of the duty to take reasonable care, or when otherwise deploying entirely objective criteria: as for instance when there might be an implication of a term requiring the fixing of a reasonable price, or a reasonable time.

Two things are noticeable when the judgment is read as a whole. One, that the Court appears perhaps to be mingling concepts of construction and of the implication of a term as a matter of fact and, secondly, that although Rix LJ speaks of good faith, he seems to be using that term, even when it appears in the same sentence, as a reference

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15 *Socimer International Bank Ltd v Standard Bank Ltd* [2008] 1 Lloyd's Rep 558.

16 *Abu Dhabi National Tanker Co v Product Star Shipping Ltd (The "Product Star") (No 2)* [1993] 1 Lloyd's Rep 397, as cited in *Socimer* at para [61].

17 At p 404.

18 *Socimer* at para [66].

to dishonesty as if those two things were synonymous, which indeed I think they may be. In the end, when he gets to the sharp end of the judgment and discusses what the bank was obliged to do, he refers only to honesty and rationality.[19] Good faith, if it was a separate concept, slides out of view.

It is Dr Peden's argument that the standard of performance of a contract ought always to be recognised as a question of construction. In this way some obligation can be imposed that did not exist on the face of the express terms. She observes that duties and co-operation are often implied terms used to fill a gap, but that it is not easy to do this where it is helping one party only – because of the old "business efficacy" test. She makes a case, if I understand her aright, for the existence of something you can imply by construction in order to spell out an obligation which is inherent, and where accordingly you can perhaps avoid the business efficacy test.

Lord Hoffmann has recently said something that bears on this. He takes the view that indeed the process of implication of a term as a matter of fact is merely a principle of construction. He confirms this in one of his last judicial utterances in giving the reasons of the Privy Council in *Attorney General of Belize v Belize Telecom Ltd*.[20]

Having said that the court cannot introduce terms to make a contract fairer or more reasonable and that it is concerned only to discover what the contract means – objectively speaking – Lord Hoffmann stated that the question of implication arises when the contract does not expressly provide for what is to happen when some even occurs.[21] Usually the answer is nothing. But, he says, in some cases:[22]

> the reasonable addressee would understand the instrument to mean something else. He would consider that the only meaning consistent with the other provisions of the instrument, read against the relevant background, is that something is to happen. The event in question is to affect the rights of the parties. The instrument may not have expressly said so, but this is what it must mean. In such a case, it is said that the court implies a term as to what will happen if the event in question occurs. *But the implication of the term is not an addition to the instrument. It only spells out what the instrument means.*

19 At paras [116] – [124].
20 [2009] UKPC 10.
21 At paras [16] – [17].
22 At para [18].

Lord Hoffmann then emphasises, by reference to *Trollope & Colls*,[23] that the implication of a term is "an exercise in the construction of the instrument as a whole".

There is only one question, he says: what the instrument, read as a whole against the relevant background, would reasonably be understood to mean. And then he cautions against treating the various tests like "business efficacy" as if they had a life of their own.[24] The word "business" conveys that the notional reader of the contract will take into account the practical consequences of deciding it means one thing or another: whether the apparent business purpose of the parties will be frustrated. The word "necessary" conveys the need for the court to be satisfied as to the meaning – it is not enough that the implied terms would have been something reasonable for the parties to agree to. Similarly the requirement that the implied term must "go without saying" is, Lord Hoffmann says, no more than another way of saying that, although the instrument does not expressly say so, that is what a reasonable person would understand it to mean. And it is not necessary that the need for the implied term should be obvious in the sense of being immediately apparent. He refers to the famous list of the five conditions for the implication of a term in fact found in *BP Refinery (Westerport) Pty Ltd v Shire of Hastings*,[25] but he says that the list is best regarded, not as a series of independent tests which must each be surmounted, but rather as a collection of different ways in which Judges have tried to express the central idea that the proposed implied term must spell out what the contract actually means, or in which they have explained why they did not think it did so.[26]

It is hard to know how far this approach will go in making it easier to imply terms as a matter of fact, but there does seem to be a real possibility that some liberalisation may occur and that gap filling will be undertaken on a less restrictive basis. If so, there will be even less need for resort to the vague notion of contractual good faith and, as Dr Peden contends, it can all be done by construing what has been said and this is how you fill in any gap.

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23 *Trollope & Colls Ltd v North West Metropolitan Regional Hospital Board* (1973) 1 WLR 601 at p 609.

24 *Attorney-General of Belize v Belize Telecom Ltd* at para [21].

25 (1977) 180 CLR 266 at pp 282–283.

26 At paras [26] – [27].

This development may assist in another way. If good faith is removed from the equation and we are left with a basic requirement for the performance of contracts in a way which is honest and within the bounds of rationality – restrictions which should not trouble any party to a contract – then it will become just a matter of the choice of words whether you have successfully given yourself the contractual powers which are necessary for your purpose. Indeed, the extent of the power will be construed with reference to that purpose. There will be no blurring overlay of some notion of good faith performance. Instead the court will simply ask what power or discretion was contracted for and is the action taken done honestly and within the scope of the power. So, when, for example, a financier has conferred on it by the contract a power to terminate the arrangement with the borrower and call up moneys which have been advanced "in its sole discretion" the court will ask itself whether, looking at the contract as a whole in its factual context there can be seen, objectively, to be any restriction on the circumstances in which it could be exercised or on the financier's purposes in doing so. Unless what the financier is doing is unconscionable or something that has been said or done has given rise to an estoppel or the borrower can invoke some other established doctrine under the general law or statute, the financier who acts honestly and rationally will not be impeded. On this view, the court will not interfere on some fuzzy basis of fairness which is where a successful appeal to "good faith" might otherwise lead.

The 26th Annual Banking and Financial Services
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Sheraton Mirage Resort, Gold Coast

31 July -1 August 2009

Friday 31 July
11:00am – 12:30pm

National Credit Reform Take 3: The Ascendance of the Commonwealth

Chair:
Elisabeth Wentworth
Barrister, Victorian Bar, Melbourne

Speakers:
Mark Sneddon
Partner, Clayton Utz, Melbourne

Alix Gallo
Head, Consumer Credit Unit, Corporations & Financial Services Division,
Commonwealth Treasury, Canberra

Steve Edwards
Director, SME Associates, Sydney

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Partner
Clayton Utz
Melbourne

CLAYTON UTZ

26th BFSLA Conference

National Credit Law Reform - Take 3 /Takeover

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31 July 2009

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Overview

- Introduction to the Reforms- FSR reprise (why?)
- The Credit Activities Net: Who needs to be registered /licensed? How in practice?
- Responsible lending obligations - how will they work?
- Roles of ASIC
- Comment

Introduction to the Reforms

- 3 July 2009: COAG agrees Commonwealth to take control
- Phase One: National Consumer Credit Protection Package -
  - 650 pages of National Consumer Credit Protection Bill and Transitional and Consequential Provisions Bill and regulations and EMs in a public consultation package released 27 April 2009 for comment by 25 May 2009 (closed industry process prior to this)
  - 25 June 2009: Revised package introduced into Parliament
  - Political pressure for speed inevitably lead to limited consultation, broad regulation requiring extensive dispensation and modification discretions in the regulator ASIC and detail deferred to Regulations
- Phase Two
  - review of specific credit issues, such as State interest rate caps, mandatory comparison rates, reverse mortgages, ***credit for business and investment purposes***
  - expect legislation for phase 2 to be in place by mid-2010

Introduction to the Reforms

- **Parallel Reforms**
  - Margin lending → Ch. 7 financial product and responsible lending
  - Unfair Terms in Consumer Contracts - ACL Part 1 as enacted in ASIC Act and TPA to take effect from 1 January 2010 with the Victorian FTA Pt 2B applying to consumer credit contracts now (will be aligned with ACL by end of 2010)

How the NCCP Works

- The State based UCCC is copied and replaced (with some changes) by a single National Credit Code (NCC) (Sch 1 of NCCP Bill). Supported by State referral of powers and federal powers.
- National registration and licensing of all persons *engaged in credit activities* in respect of *credit to which NCC applies* - broadly similar to the AFSL regime, overseen by ASIC - lots of new fish in net.
- Licence conditions, conduct obligations (including responsible lending) and disclosure obligations - superintended by ASIC. FSR reprise.
- Civil penalty and criminal penalty regimes for licensee misconduct. Civil penalty infringement notices (fines) - regulated by ASIC.
- Consumer compensation remedies. Three levels of dispute resolution - IDR, ASIC-approved EDR (licence requirement), State and Federal Courts (small claim procedures for claims up to $40,000).

Timing to be licensed/registered?

- **Registration requirements**
  - all persons currently engaging in credit activities will need to apply to ASIC for registration between 1 November 2009 and 31 December 2009
  - Membership of approved EDR scheme required for registration and licensing
- **Licensing requirements**
  - upon registration, persons need to apply to ASIC for licence by 30 June 2010
  - From 1 January 2010, any person engaging in credit activities for the first time must apply to ASIC for a licence

Big Net - Who must be licensed/registered?

- Persons and entities who ***engage in credit activities*** in respect of ***credit to which the NCC applies*** must be licensed or be an authorised representative of a licensee.
- ***Credit to which the NCC applies*** is credit to be provided under a credit contract to a natural person or strata corporation for which a charge is or may be made and is provided wholly or predominantly
  - a) for personal, domestic or household purposes; or
  - b) (NEW) to purchase, renovate or improve residential property for investment purposes; or
  - c) (NEW) to refinance credit described in (b)
  - "Residential property" covers land for residential dwellings and rights to occupy aged care facility or retirement village)
- ASIC can exempt persons and classes from licensing - e.g. POS

Credit activity

- Two broad categories of credit activities:
  - ***credit providers*** under a NCC credit contract, ***lessors*** under NCC consumer leases, ***mortgagees*** under a NCC mortgage, ***beneficiaries*** of NCC guarantees and ***assignees at law*** of any of these;
  - persons who provide ***a credit service -*** defined as
    - providing ***credit assistance*** or
    - acting as an ***intermediary*** for the purpose of securing a consumer contract or a consumer lease

Credit Activity

A person or entity will be engaging in a "credit activity" if they:

- are a credit provider under a credit contract or lessor under a consumer lease
- carry on business of providing Code-regulated credit or providing consumer leases
- perform obligations or exercise rights in relation to a current or proposed credit contract / consumer lease
- are a mortgagee (or perform obligations or exercise rights) under a Code-regulated mortgage
- are a beneficiary (or perform obligations or exercise rights) under a Code-regulated guarantee
- are an assignee from a credit provider / lessor exercising assigned rights
- provide a credit service

Credit Service

- Credit Service
  - A person or entity provides a "credit service" if they:
    - provide "credit assistance" to a consumer; or
    - act as an "intermediary"
- Credit Assistance
  - A person or entity provides "credit assistance" if they:
    - deal directly with a consumer / consumer's agent;
    - "in the course of", "as part of" or "incidentally to" a business carried on by them in Australia; and
    - "suggest" or "assist" regarding regulated credit

Credit Assistance: "suggest" or "assist"

- A person or entity will be regulated where they:
  - suggest consumer applies for credit or for limit increase under, or remains in, a particular credit contract / consumer lease with a particular credit provider / lessor; or
  - assist the consumer regarding application for credit or consumer lease or credit limit increase
- Must involve a particular credit contract or lease (general suggestions and assistance not caught)

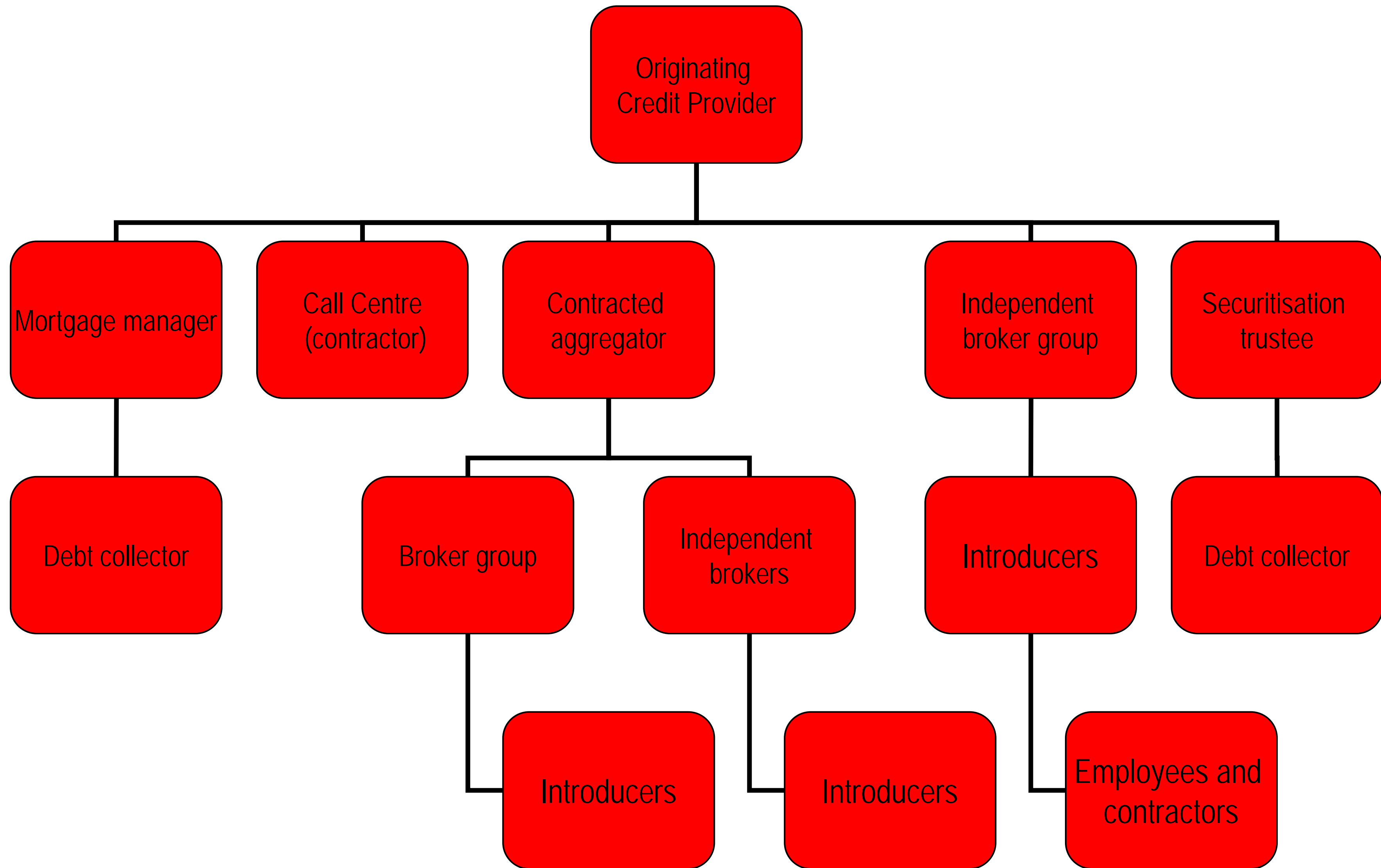
Acting as an Intermediary

- A person or entity covered if they act as an intermediary:
  - directly or indirectly between a credit provider / lessor and a consumer, wholly or partly for securing provision of regulated credit / consumer lease
  - "in the course of", "as part of" or "incidentally to"
  - a business carried on by them in Australia
- Government intends to cover every intermediary between a credit provider and consumer (subject to exceptions)

Credit Representatives of Licensees

- Taking another leaf from FSR, a licensee can authorise a person in writing to engage in specific credit activities on behalf of the licensee.
- Credit representatives do not need a licence when so acting.
- A body corporate representative can sub-authorise a natural person if the licensee consented in writing.
- Licensees are generally responsible for their representative's conduct for any loss or damage suffered by a client reasonably relying on that conduct.
- Licensees can authorise a person to be a representative of 2 or more licensees if each licensee consents or the licensees are related bodies corporate. Multiple licensees authorising the same representative are generally jointly and severally liable to the client. Licensees and representatives may take indemnities from each other.

What will this do to business models?



Obligations of Licensees

- Licensees' obligations include:
  - ensure credit activities authorised by the registration are engaged in efficiently, honestly and fairly
  - have in place adequate arrangements to ensure that clients are not disadvantaged by any conflict of interest that may arise
  - comply with licence conditions and credit legislation (and take reasonable steps to ensure representatives comply with credit legislation)
  - Unless APRA-regulated, have adequate resources (including financial, technological and HR) to engage in the authorised credit activities and to carry out supervisory arrangements and have adequate risk management systems

Obligations of Licensees

- Maintain competence to engage in the authorised credit activities
- ensure that its representatives are adequately trained and competent to engage in the authorised credit activities
- have a compliant internal dispute resolution procedure
- be a member of an approved external dispute resolution scheme
- have compliant compensation arrangements in place
- have adequate arrangements and systems to ensure compliance with its obligations and a written plan documenting arrangements and systems
- Breach reporting was removed during consultation - instead licensees must provide an annual compliance certificate

Responsible Lending

- Intended as a supplement to a licensee's general conduct licence obligations to operate efficiently, fairly and honestly
- Responsible lending obligations apply from 1 January 2011 when licensees:
  - enter into consumer credit contracts (or credit limit increases) with consumers or consumer leases
  - suggest a consumer enter into a particular credit contract (or credit limit increases) or consumer lease with a particular credit provider
  - assist a consumer to apply for a particular credit contract (or credit limit increases) or consumer lease with a particular credit provider
- The responsible lending obligations are slightly different depending on whether the licensee is giving ***credit assistance*** or a ***credit provider / lessor***

Responsible Lending - Credit Assistance Providers

- The key responsible lending obligations applicable to licensees who provide credit assistance include obligations to:
  - provide a credit guide;
  - provide a quote for credit assistance;
  - make a preliminary assessment of unsuitability;
  - disclose fees and a reasonable estimate of commissions in a credit/lease proposal disclosure document; and
  - *ensure that the licensee does not suggest or assist a consumer to enter into, increase the credit limit under, or remain in, an unsuitable credit contract or consumer lease.*

Responsible Lending - Credit Assistance Providers

- **Exceptions - no duplication where credit provider is also assister**
- A credit provider who provides credit assistance in relation to a credit contract for which it will be the credit provider and a lessor who leases solely on proprietary contracts are not required to perform the *credit assistance* responsible lending obligations (but must perform the credit provider/lessor obligations)

Responsible Lending - Credit Providers + Lessors

- The key responsible conduct lending obligations applicable to credit providers and lessors under consumer leases are to:
  - provide a credit guide;
  - make an assessment of unsuitability of any relevant consumer lease or relevant credit contract / credit limit increase under credit contract;
  - ensure the licensee does not enter into:
    - an unsuitable credit contract with, or increase the credit limit of a credit contract with, a consumer who is the debtor under the contract; or
    - an unsuitable consumer lease with a consumer who is the lessee under the lease.

Responsible Lending: Assessments

- Reasonable inquiries to be made for preliminary assessment of unsuitability and for unsuitability assessment:
  - make reasonable inquiries about the consumer's requirements and objectives for the credit contract;
  - making reasonable inquiries about the consumer's financial situation; and
  - taking reasonable steps to verify the consumer's financial situation.
- Credit contract is unsuitable if either assessment finds that:
  - consumer is likely to be unable to comply with financial obligations under contract, or could only comply with substantial hardship; or
  - contract will not meet consumer's requirements and objectives.

Responsible Lending

- Substantial hardship is presumed if a consumer could only comply with the relevant obligations by selling their principal place of residence
- Impact on refinancing
  - Level of inquiry required to meet 'reasonable inquiries' standard is likely to be greater where the consumer is refinancing (particularly where difficulties meeting repayments, in arrears, on their existing contract).
  - Where a consumer currently unable to meet repayments under contract, a contract with same or a similar level of repayments will be prima facie unsuitable

How will suitability assessment work?

- Credit limit increases - for cards currently usage pattern and general profile generated - now dead?
- What are reasonable inquiries re financial situation?
- What are reasonable steps to verify?
- Low doc loans dead? Is that good?
- What assumptions can guide "likely to be unable to comply" with financial obligations?
- How are the consumer's requirements and objectives to be ascertained/corralled/recorded/reviewed?

What is left to the regulations?

- Regulations to the Credit Bills will be tabled in Parliament after the enactment of the Credit laws. Regulations expected to cover:
  - treatment of interest paid in advance for residential investment property
  - setting of fees and charges for lodgement of a licence application and licence renewal
  - exemptions from licensing - for example, exemptions for state-licensed debt collectors (12 months only) and for point of sale credit assistants
  - clarifying the application of responsible lending requirements relating to certain disclosure documents
  - clarifying application of responsible lending provisions
  - establishing the infringement notice regime
  - clarifying the jurisdiction where legal proceedings must be commenced
  - streamlining to licence brokers who hold either an 'A' or 'B' class licence under the *Finance Brokers Control Act 1975* (WA)

Role of ASIC

- ASIC needs to be resourced with money and people to act as policy maker, legislator, guide and enforcer
  - ASIC has power to exempt or modify the application of licensing requirements
  - ASIC can exclude provision of credit (by instance or class) from NCC
  - ASIC will be able to exercise discretion in imposing penalties where persons have attempted in good faith to comply
- Policy consultation and guidance papers and stakeholder engagement to Oct 09 and beyond
- Consultation papers released on 15 July 2009
  - Consultation Paper 110 - General conduct obligations for credit licenses (attaching draft Regulatory Guide 104)
  - Consultation Paper 111 - Compensation and financial resources arrangements for credit licensees
- Regulatory guides to be released after passing of legislation and will take into account comments received on consultation papers

Comments

An artificially short political time frame for this reform led to:

- pressed Treasury policy makers using a flawed precedent (FSR) to meet deadlines
- a consultation process constrained by confidentiality deeds and secrecy and a too short public period meaning input from business and even State and Territory
- a model of overbroad general regulation which requires too much post-enactment adjustment by regulation, and excessive amounts of regulator dispensation and discretion and guidance

Not the fault of ASIC or (principally) of Treasury but a lamentable re-run of FSR - let's not do it again for Tranche 2.

Comments

- Don't forget unfair contract terms reforms will apply in addition to NCC unconscionable fee and charges provisions- ASIC can use both routes - be on watch re early termination and deferred establishment fees
- Licensing/ conduct obligations for some operators and RL unsuitability assessments are good ideas in principle but needed much more nuancing and practical commercial input as to how the credit business actually works.
- We are now in the era of ASIC (policy maker, legislator and enforcer) and the EDR schemes as interpreter/policy maker and judge (e.g. FOS up to $250K) (if they can cope with the demand).

CLAYTON UTZ

26th BFSLA Conference

National Credit Law Reform - Take 3 /Takeover

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National Credit Reform Take 3: The Ascendance of the Commonwealth

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CORPORATIONS AND FINANCIAL SERVICES DIVISION

THE TREASURY

"National Credit Reform Take 3: The Ascendance of the Commonwealth"

Banking and Financial Services Law & Practice Conference 2009

31 July 2009

Good morning. Today, I have been invited to update you on the work that the Australian Government is doing to reform the national credit laws. In particular, I have been asked to talk about how we developed the law and some of the challenges we faced along the way.

I would like to begin with a brief outline of the key elements of the national credit reform, then talk about how we got there; and where we go from here. Despite the title of this segment of the program, I hope to show you that this reform process has been (and needs to be) essentially a cooperative effort between the Australian Government, industry and consumer groups.

Creating national and consistent consumer credit law

On 25 June, a reform package was introduced into Parliament to modernise Australia's consumer credit laws.

The package will – for the first time – provide for one, standard, nationally consistent regime which applies equally to all credit consumers and all credit providers, right across the country.

The reforms include all consumer credit — mortgages, credit cards, and some r(esidential and margin lending) investment lending to over 5.7 million Australian households. It also covers brokers and credit advisers.

As well as providing consistency and certainty, the new regime will also reduce duplication and the compliance burden for business.

In effect, it will replace up to 2,500 pages of multiple State laws with one national regime.

The reforms follow the decision by the Council of Australian Governments in October 2008 to transfer responsibility for all consumer credit products to the Commonwealth. The agreement is part of COAG's vision for a seamless economy.

The primary legislation, the *National Consumer Credit Protection Bill 2009,* together with two ancillary bills – covering the *National Consumer Credit Protection (Transitional and Consequential Provisions) Bill*, and the *National Consumer Credit Protection (Fees) Bill*, will introduce two new elements into the consumer credit landscape.

These are a comprehensive national licensing regime enforced by a single regulator, and responsible lending requirements.

National licensing regime

Under the new regime, all lenders and providers of consumer credit broking services, including intermediaries, will be required to obtain an Australian Credit Licence from the national regulator, ASIC, which will have significantly boosted enforcement powers.

Industry participants will need to be registered or licensed if they:

- provide credit or consumer leases;
- collect money due under a credit contract or a consumer lease;
- exercise rights as a mortgagee or the beneficiary of a guarantee;
- act as an intermediary between the borrower and the lender. This principally covers finance brokers, however the definition also covers bodies such as mortgage managers and aggregators; or
- suggest or provide assistance in respect of a specific credit contract or lease with a particular credit provider.

To help industry adjust to the new regime, there will be a transitional phase.

The licensing process will start on 1 January 2010. Before that date, anyone engaging in credit activities will need to be registered with ASIC, and must apply for registration between 1November 2009 and 31 December 2009.

They will then have the six-month period between 1 January 2010 and 30 June 2010 to apply for an Australian Credit Licence.

Anyone who engages in credit activities for the first time on or after 1 January 2010 must apply for, and receive, an Australian credit licence before starting business.

To qualify for an Australian Credit Licence, lenders must meet minimum training requirements and have adequate financial and human resources to meet their obligations.

Licensees must also meet enhanced standards of conduct including the requirement to act honestly, efficiently and fairly. They must also properly train and supervise people who act on their behalf.

As well, licensees must be members of an external dispute resolution scheme. This means that, for the first time, consumers will be able to resolve consumer credit disputes outside the court system at no cost.

ASIC will be given the power to take action promptly to cancel or suspend a licence, or to ban people from engaging in credit activities.

A national licensing scheme means that a person who is banned or loses their licence or registration will be excluded Australia-wide. Currently, there is nothing to prevent a person banned in one State or Territory from continuing to operate as a broker or lender simply by moving to a different jurisdiction.

Authorised Deposit-taking Institutions can be streamlined to a licence because we are confident that these institutions already satisfy the entry requirements.

Responsible lending obligations

The Government is also providing an enhanced level of consumer protection by requiring all brokers and lenders to play their part in lending responsibly.

The National Consumer Credit Protection Act will establish new responsible lending conduct requirements.

When offering any form of consumer credit, lenders and other financial advisers such as finance brokers, will be required to do two key things.

First, they must assess that the loan is not unsuitable for the consumer. And secondly, they must assess whether they reasonably believe the consumer would have the capacity to repay the loan. In making this assessment, they will need to make reasonable inquiries and verify the details provided to them.

All consumers applying for credit will be provided with a Credit Guide which will inform them of key information early in the process of a credit-related transaction. It is important that the consumer knows who they are dealing with, that the credit provider is licensed — and has therefore met the stringent entry requirements of participating in the credit market — and also has early advice of any fees and costs.

As part of the responsible lending requirements, licensees will also have to let consumers know, upfront, what fees and charges they will need to pay before the loan is suggested or

entered into. As well, lenders and brokers will need to disclose general information about fees and commissions, complaints resolution - and information considered helpful to inform consumer choice. These provisions will help consumers to make better informed choices.

New mandatory dispute resolution mechanism

The new regime will introduce for the first time, a mandatory industry-wide three-tier dispute resolution system for consumer credit issues, making it easier and less costly for consumers to resolve disputes.

The three-tier system will give consumers access to:

- the licensee's internal dispute resolution process;
- an ASIC-approved external dispute resolution scheme; and
- the Federal Court, Federal Magistrates Court and the courts of the States and Territories (including the Magistrates or local Courts).

Lenders, brokers and other credit service providers will be required to provide consumers with access to both internal and external dispute resolution.

What is new however, is that consumer access to the courts has been enhanced via a new "opt-in" streamlined procedure for hardship matters, and compensation claims for loss or damage up to $40,000.

The "opt-in" streamlined procedure will provide consumers with informal court proceedings where legal forms and technicalities do not have to be observed and legal representation is not required.

This is a robust system designed to provide consumers with access to justice. In developing the model, we took care to ensure continuity with the current arrangements, and to allow effective low-cost court options to remain available for consumers.

Boosted enforcement powers for ASIC

The Government is backing its tough stance on consumer protection with substantially increased powers for ASIC.

The regulatory framework is supported by a tiered approach to the sanctions and enforcement regime, which includes:

- criminal penalties for licensee misconduct, including possible imprisonment for up to two years for those who lend contrary to the responsible lending requirements;
- civil penalties for licensee misconduct which enable ASIC to seek fines of up to $220,000 for an individual and $1.1 million for a corporation;
- infringement notices enabling ASIC to act quickly to penalise certain breaches of the law; and
- consumer remedies, such as compensation, which allow consumers to seek redress for their loss and damage from a licensee.

These provisions are consistent with the *Corporations Act 2001* and other Commonwealth consumer protection laws. They are targetted at preventing consumer detriment through deterence; and ensuring that ASIC is fully equipped and able to take appropriate and proportionate action to deal with breaches of the law.

Transition and ASIC's role

To ease the transition for industry and allow the national credit regime to be implemented in a sensible and practical fashion, ASIC will have a pivotal role in the period ahead.

During the transition period, ASIC will undertake intensive stakeholder consultation to explain and clarify the regulatory requirements to stakeholders. ASIC will also work closely and cooperatively with industry to develop guidance material to help industry in the shift to the new regulatory environment.

This work has already begun. ASIC has already begun to issue consultation papers in line with its program of industry engagement to provide guidance and clarity on key elements of the new law – such as competency and training, general conduct obligations; compensation and financial resources arrangements for credit licensees.

PART B – Reflections on the development of the law

I'd like to turn now to the process of developing the reform package. I'd like to offer some general reflections on how we approached it, the challenges we faced and the key tensions and principles that shaped the final package.

Developing the National Credit Law

Our Starting Point

In March last year, COAG agreed that the regulation of mortgages, mortgage broking & margin lending will be transferred to the Government. This was followed by an agreement in July, that the C/W would assume regulatory responsibility for all consumer credit.

As this is a massive undertaking, the Government agreed that the transfer of regulatory responsibility from the States to the Commonwealth would be achieved in two phases.

The Government's blue print for reforming consumer credit were canvassed in the Financial Services and Credit Reform Green Paper — *Simplifying & standardizing financial services & credit regulation*) released in June 2008 — which drew heavily from the recommendations of the Productivity Commission's report, *Review of Australia's Consumer Policy Framework,* released in May 2008.

Submissions received in response to the Green Paper signaled overwhelming support for the C/W to assume regulatory responsibility for all consumer credit & for ASIC to be the national regulator.

There was unanimous agreement that any attempt to limit the scope of the new regime to certain credit products & services was sub-optimal and would give rise to 'boundary line' problems.

Policy objectives and guiding principles

While all levels of government were keen to move quickly on this reform, the impact on business and consumers was of paramount consideration.

The Government stipulated two requirements. Firstly that the transfer should be as smooth and seamless as possible, with minimal business disruption. And secondly, that the reform package maintain the level of consumer protection that exists today – and where possible enhance those protections.

We recognised early in the process that an optimal regulatory framework would need to strike a balance between enterprise, on the one hand, and protection of consumer interests, on the other. To maximise our chances of achieving the right regulatory balance, we sought to build our regulatory framework around some key principles, two of which are **flexibility** and **transparency.**

The tension between certainty and flexibility featured prominently in the development of the national credit framework.

Clearly, certainty is important for those who are subject to the regulation. But flexibility is also important, as it allows rules and regulations to be adapted to address unforseen, new or changing situations. This flexibility provides the space, and the incentive, for markets and industries to innovate and thrive.

This is why we have deliberately adopted a principle-based legislative approach, with broad regulation making powers, to allow quick responses to changing market circumstances. This undelines much of the thinking behind our regulatory design of the licensing regime and the conduct obligations. Our preference was not to be prescriptive in the law by setting out in detail what must be done to comply with the law.

Transparency is a fundamental principle of the regulation. It is the result of disclosure of information, which enables market participants to assess and compare the quality of the service or product being offered.

The responsible lending obligations require brokers and credit providers to disclose certain information to consumers. And hopefully, this will result in better outcomes for consumers.

But of course, regulation which possesses the key attributes of certainty, flexibility and transparency will not necessarily guarantee successful regulation.

The success of any regulatory reform will depend, to a large extent, on the commitment of regulators and policy makers to constructively engage with the parties that continue to have a stake in the evolution of the reform agenda — that is consumers, industry; and State governments and key regulatory agencies.

Development Issues

The project was also shaped by a number of imporatnt factors: the timetable was set at eth direction of COAG had been brought forward by six months.

A key policy decision was taken early on to construct the core of the new law around the existing State Uniform Consumer Credit Code (UCCC). This reflected a promise to industry that the current regime would continue; and recognition that the UCCC was fundamentally sound, but had significant gaps, which the States had sought to address through the development of draft NSW finance brokers Bill and other amendments.

A complete overhaul of a systems-intensive regime like the UCCC, would have been extremely costly and disruptive to industry and could not be justified. Hence it was logical to adopt the UCCC and enhance it by building a national licensing system around it and adding other reforms. In that way reforms already in contemplation by the States could be picked up as appropriate. This approach also had the advantage of building on the existing systems experience and expertise.

As I've mentioned, a significant decision was to proceed by stages. In the initial stage, it was decided to focus our efforts on areas of systemic gaps – for example licensing and the absence of broker regulation, elements which the states had sought to introduce for some time.

The process of replicating the credit code into Commonwealth law posed unique challenges – in so far as the code had to be made to harmonise with areas of Commonwealth policy such as criminal law and Commonwealth judicial power – and this was a key factor in our system design.

Role of the State and Territory Governments and Referral of Power

The state governments are key stakeholders in the COAG credit reform agenda, which is based on a sustained cooperative effort between the states and territories, and the Australian Government. At the heart of the reform is the referral of state constitutional power to eth Commonwealth. This will be supported by agreement on the arrangements involved in 'switching-off' state responsibilities for credit regulation and the 'switching-on' of national credit laws with the transfer of state powers to the Australian Government.

A referral of state constitutional powers is a complex process which requires the Australian Government and the State Governments to determine the scope and the form of the referral. Importantly the States have agreed to refrain from legislating in this area. The withdrawal is fundamental to the COAG reform agreement.

The States are committed to delivering on the agreement. They will continue to make available their regulatory experience to the development of future Commonwealth legislation in Phase 2. Importantly, they are committed to directing their policy development in this area to support the overall credit reform agenda.

Consultation of key stakeholder groups

Following the consultation process that started with public submissions to the Green Paper, we consulted extensively with stakeholders. The consultation for all its strengths and weaknesses, should be seen against the background of previous state government efforts to regulate brokers and introduce other reforms to address predatory lending – amid extensive debate and policy analysis.

To promote public understanding of the task at hand, a series of public information sessions were undertaken in capital cities. We also implemented a comprehensive consultative process with our key stakeholders — State government regulators, industry groups and consumer bodies.

A consultation group was established consisting of peak industry associations and consumer groups. Regular meetings were held with this group to develop the policy underlying the legislation. The group also had the opportunity to review draft legislation and regulations before it was exposed for public comment in April.

In addition, specialised consultative groups were established

- to provide input into the design on specific issues such as the regulation of margin lending, and a simplified product disclosure statement for margin loans; and
- to oversight the replication of the UCCC into Commonwealth statute to ensure that the policy of the code, was as far as possible preserved.

Stakeholder Issues and response

The consultation process has been important and enlightening. It has exposed some important arguments and differences of view and left us, we hope, with a more robust statute than might otherwise have been the case.

It was instructive in revealing, not only the shortcomings of our framework, but also its strengths. Overall however, there was broad concensus that:

- an appropriate regulatory balance had been struck;
- it was desirable to have a level playing field across industry by requiring all industry participants to meet required conduct obligations and standards; and
- licensing should over time work to lift industry standards; and that if that necessarily meant those who cannot comply exit the industry, this is not necessarily a bad outcome.

In response to views expressed by stakeholders following public exposure of the Bills, we made some important policy adjustments. In particular, to minimise the compliance burden for business and consumers, transition periods have been extended to give industry stakeholders, especially lenders, more time to prepare their systems for the introduction of the new regime.

Firstly, we have simplified the way in which the proposed responsible lending arrangements will apply. We have removed the requirement for lenders to meet credit assistance conduct obligations when providing assistance in relation to their own credit products.

Secondly, we have delayed the commencement of the responsible lending obligations to 1 January 2011. This will give industry more time to implement the necessary changes to support responsible lending.

Thirdly and importantly, the Government has given ASIC greater flexibility to exempt or modify the licensing and registration requirements in the law.

Another key change in response to stakeholder submissions was the introduction of a provision [section 47(2)] to allow for the level of compliance to vary according to the nature, scale and complexity of the crdit activities engaged in by a licensee.

The Government has given ASIC greater resources to ensure it will be active in assisting industry to comply with the law. ASIC has already commenced an intensive industry consultation to explain and clarify the licensing requirements, and will work closely and cooperatively with industry. This is in stark contrast to the Financial Services Reform (or FSR) experience – where regulatory implementation did not occur in tandem with industry engagement.

The Government will continue to be closely engaged with industry, consumer groups and State governments throughout the implementation and transition to the new national regime.

Phase 2 implementation

The second implementation phase will take this project even further.

In Phase 2, the Australian Government will focus on enhancing the regulatory framework by considering regulation to address specific unfavourable lending practices. One example of an unfavourable lending practice is deceptive or misleading advertising. Mechanisms for more comprehensive coverage of consumer credit, targetting obvious avoidance techniques are proposed. It will also include consideration of further measures to address equity stripping practices, where credit is provided that effectively results in a transfer of significant amounts of equity from the borrower to the lender or broker.

ASIC's 2008 report, *Protecting the Wealth in the Family Home*, reviewed three borrowers in detail and found that the refinance cost them on average 27% of the equity they had accumulated in their home, and a minimum of $20,120 in fees and charges.

We will also consider what regulation and tailored disclosure is needed for reverse mortgages and other equity release products. Reverse mortgages allow a person to borrow cash against the value of their home.

The main feature of these loans is that regular repayments are not necessary as fees and interest are added to the loan balance. The total amount owing is then deducted from the sale of the home when you die. While this may be one way of accessing the stored equity in your home, particularly when you don't have sufficient income for a normal loan, it is usually a very expensive source of funding.

The problem is that it is highly likely that the amount of the loan will finally exceed the value of the home, and the resident — who by this stage is usually very elderly — could be evicted so that the home can be sold to pay the debt.

As well, during Phase 2, we will also consider the possible extension of the new national scheme, beyond just consumers, to the provision of credit for small business and investment loans – where there are net benefis for regulatory intervention.

The legislation to implement Phase 2 is scheduled for completion by mid-2010.

Conclusion

As you can see, the new reform package introduces generational changes to our consumer credit laws. As well as making the consumer credit system fairer, more consistent and more workable, the new regime is designed to provide a far higher level of protection to consumers.

And over time, it will lead to an improvement in industry standards.

We have a lot more work to do before we can say we are fully exploiting the opportunities of a uniform national credit approach, but we are on the way. In fact we are nearing the beginning of the real challenge — implementing the new regime and making it a success in practice.

Will the new regime succeed? Ultimately, its success will depend on close collaboration between ASIC and all market participants, industry and consumers alike.

By working together, ASIC and all market participants now have a very real opportunity to create a world-leading regulatory system and Australia will be a better place for it.

Thank you.

The 26th Annual Banking and Financial Services Law and Practice Conference

Sheraton Mirage Resort, Gold Coast

31 July -1 August 2009

National Credit Reform Take 3: The Ascendance of the Commonwealth

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Policy Objectives - Stated

- Delivering single, standard, national regulation of consumer credit for all Australians

- Code objectives remain the same
  - to ensure strong consumer protection through '**truth in lending**'
  - recognising competition and product innovation must be enhanced and encouraged by the development of **non-prescriptive flexible laws**.

Reform Drivers – The Reality

- Processes
  - MCCA processes ineffective
  - Inability to respond quickly to market developments
- Policy
  - National broking regulatory regime
  - Payday lending
  - Disclosure effectiveness
  - Consumer capacity – ‘responsible lending’
  - Regulator inaction – enforcement issues
- Code, of itself, effective

Key Considerations

- Scope/Reach
- Operational impacts
- Consumer benefit
- Cost benefit
- Consultation process

Scope/Reach

- COAG approach broader than policy drivers
  - FSR type regime imposed
  - No market failure to justify imposition of licensing regime on credit providers
  - Failure to consider where risk lies – not with consumer but with credit provider
- Capture of service providers already regulated
  - Lack of market knowledge = increased regulation
  - Complexity of relationships ignored – should the repo agent be captured?
  - Increased regulatory burden, not less
- Confusion of FSR type regime on functions
  - How to distinguish a broker from a lender?

Scope/Reach

- Broker regime less than currently exists
  - 12 month deferral of responsible lending provisions
  - Key policy driver unresolved
- Increased overall disclosure, not less
  - Despite current research on effective disclosure
- Consumer capacity – ‘responsible lending’ deferred
  - Key policy driver unresolved
- Cost benefits
  - Unassessed

Operational Impacts

- **Multiple regulators**
  - Potential for States to legislate on credit & they are
  - Results in increased legislative and compliance requirements
- **Lack of operational certainty**
  - Details still to be finalised – Regulations & ASIC compliance policies & guidances
  - Exemptions – limited application
  - Interest in advance residential investment property loans
  - Licensing process & requirements
- **Compliance management**
  - Inadequate compliance time frames
  - Demands on limited resources – other major legislative changes occurring
  - Introducer and service provider business models
  - Training
  - Documentation revisions – multiple times
  - Costs - business models, relationships, policies, procedures, documents, systems etc

Relationships Under Review

- Credit Provider/Introducer and Service provider business models
  - Need time to evaluate implications & risks & rewrite contractual agreements
- Vendor introducers – a confused compliance position
  - Exempt for 12 months from 'credit assistance'
  - Inadequate scope of exemption
    - credit activities of 'intermediary' & 'performing functions on financier's behalf' still require compliance
- Debt collectors – competition issues
  - Agents exempt for 12 months pending consultation with States/Territories, if licensed
    - Impact on ACT collectors?
  - But, debt purchasers must hold ACL
    - Competition issues?
    - Impact on market conduct?

Consumer Benefit?

- Consumer benefit
  - No assessment – assumed but potential detriments
    - Roles, credit guides, mixed messages in important docs etc
  - No consumer focus groups etc in development
- Disclosure research
  - MCCA-commissioned research into effective pre-contractual disclosure not available to inform disclosure approach
- Responsible lending
  - Credit product 'not unsuitable' test – how subjective
  - Unwarranted intrusion into consumer choice?
  - Product implications?

Consultation process

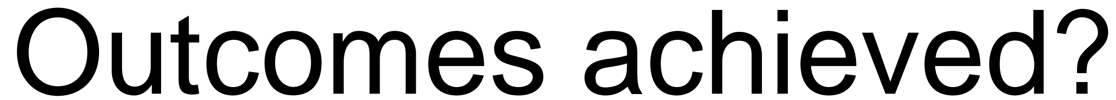
- Inadequate consideration of issues
  - Focus not on best regulatory outcome
  - Rushed process
- Closed
  - Many stakeholder groups excluded
  - Outcomes compromised by limitations on consultation
  - Threat of *Crimes Act* action not a hallmark of open, accountable government

Cost Benefits - Questionable

- Consumers
  - Increased compliance costs = increased credit costs
  - Possible lessening of product and provider choices
  - EDR potential to drive up credit costs & confuse processes

- Licensees
  - Increased compliance costs, now and ongoing
  - Potential decrease in competition
  - Potential ongoing regulatory reforms to address operational issues
  - Potential for multiple credit jurisdictions

- Regulators
  - Administration regime broader than anticipated?
  - Potential ongoing regulatory reforms to address operational issues
  - Compromised regulator/stakeholder relationships through consultation process



- Single, standard, national regime
  - provided States don’t regulate
  - But will EDR schemes become the new regulators?
- Truth in lending
  - Requires effective disclosure regime
  - New disclosures may prove to be counter-productive or ineffective
- Non-prescriptive, flexible laws
  - Policy perspective lost
  - Product offerings compromised

Conclusion

- Questionable benefits for any stakeholder group

- Areas for improvement
  - Evidence-based policy development
    - Targetted policy development – not one size fits all
    - Understanding of market complexity & risk required
  - Transparent/inclusive consultation
  - Cost benefit analyses
    - For all stakeholder groups
  - Regulatory Impact Assessment
    - to consider all other regulation that impacts on the credit function

Steve Edwards

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legal & compliance services - finance industry regulation

The 26th Annual Banking and Financial Services Law and Practice Conference

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Friday 31 July
11:00am – 12:30pm

Set-off as a security device

Chair:
Jason Morris
Partner, Allens Arthur Robinson, Melbourne

Speakers:
Associate Prof. Sheelagh McCracken
Applied Finance Centre, Macquarie University, Sydney

Jason Boyes
Partner, Buddle Findlay, Wellington

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Set-off as a security device

Associate Prof. Sheelagh McCracken
Applied Finance Centre
Macquarie University
Sydney

SET-OFF AS A SECURITY DEVICE:

accuracy of perceptions and implications for third parties

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BFSLA Conference, Gold Coast Qld
31 July 2009

Set-off as a security device:

accuracy of perceptions and implications for third parties

1. Introduction.

While discussion at this Conference will no doubt reveal many lessons to be learnt from the 'credit crunch', this paper contends that one critical lesson is the need for financial institutions to ensure not only that they have the power to exercise a set-off but that they understand the level of protection which it offers. Those who claim, for example, to be secured in a particular transaction by way of set-off may find themselves disappointed when they seek to exercise the set-off and discover that it does not operate as they anticipated. A description of set-off as a security might have led them to expect to obtain a proprietary interest in the debt sought to be set-off; such expectation will not, however, necessarily be fulfilled.

There is no doubt that the financial crisis has highlighted the importance of set-off. In normal trading conditions in Australia where two persons have mutual dealings, each may be reluctant for whatever reason to pay their debt in full when they are each owed money by the other. They may find it much more convenient to set-off their claims and have only the net balance payable. A set-off is usually preferable to incurring costs and expending time and effort in bringing proceedings against each other if the relationship deteriorates. A set-off can be especially valuable for an Australian resident if the other party operates in a foreign jurisdiction, where the ability to bring proceedings against that party may be uncertain as well as expensive.[1] It is, however, in circumstances where credit is 'tight', that the availability of such a remedy of set-off becomes critical. A reluctance to make full payment experienced in normal times becomes significantly heightened through the increased risk of insolvency. No person - individual, corporation or financial institution - wishes to pay out when the likelihood of recovering the debt owed to it in insolvency proceedings is minimal.

While set-off has long been relied upon in the general commercial world,[2] it clearly has particular significance in the finance sector where debts are constantly created and traded or otherwise dealt with. Viewed from the perspective of a financial institution, set-off has the potential to offer an effective remedy which is equivalent in an important sense to recovery of the debt owed to it. As Lord Hoffmann explained in 1995 in *Stein v Blake* [1995] 2 All ER 961 at 964:

> Instead of having to prove with other creditors for the whole of his debt in the bankruptcy, he can *set off pound for pound* what he owes the bankrupt and prove for or pay only the balance. (emphasis added)

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[1] See Australian Law Reform Commission Report No 80 *Legal Risk in International Transactions,* AGPS, Canberra (1996) pp 126-128.

[2] See eg Braudel, *The Wheels of Commerce*, Fontana Press London 1985 at pp 90-91 where he examines the activities of the medieval European fairs and likens the process of settling accounts 'in which debts met and cancelled each other out' to snow melting in the sun.

The process is not, however, equivalent for all purposes. If the creditor in fact recovered the debt, it would receive the full amount owing and could use that amount as it wished. In a set-off, the creditor's action is restricted to the set-off of the debts.[3]

In offering a remedy, set-off certainly provides a level of comfort to the financial institution. Yet the precise nature and scope of that comfort is surprisingly unclear. The purpose of this working paper[4] is to explore one argument which has been increasingly discussed in commercial practice and which has accordingly given rise to this Conference Session, namely, the argument that set-off is to be regarded as a security. Unfortunately this is not a straightforward argument. Indeed the very title of the Session 'Set-off as a Security Device' reflects a measure of ambiguity inherent in the argument – the meaning of the term 'security'. Is set-off itself a security interest, in the technical legal sense of conferring rights over property? Alternatively, does set-off rather provide security in a looser, more commercial, sense insofar as its exercise is recognised in insolvency proceedings and results in a creditor not having to stand in line with other unsecured creditors?

Furthermore – and irrespective of which interpretation is given to the title - the title clearly assumes that set-off is, in some form or other, appropriately characterised as a security. That is, however, an assumption that requires examination. Certainly, there are some judicial statements, at appellate level as well as first instance, which –taken initially at face value- appear to suggest that set-off is indeed a security. Moreover and very importantly from the perspective of this Conference's audience of experienced practitioners, commercial documents typically used in the Australian financial markets appear not infrequently to be drafted on the basis that set-off is, or has the effect of, a security. Yet leading textbook writers are generally quick to dismiss the notion that it is a security.[5]

It is a central theme of this paper that differing views of set-off's role as a security can be attributed, at least in part, to a lack of consensus over how set-off actually operates; and in particular, to a difference in opinion as to whether it operates as a discharge of a personal obligation to make payment or as an appropriation of property for the purposes of making payment. It becomes therefore of fundamental importance to understand the possible bases on which these views have been formed, particularly since they appear rarely to be expressly articulated. Accordingly, the first section of this paper outlines the various ways in which the process or 'mechanism' of set-off may be interpreted as operating.

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[3] It does not purport to give any rights over any other property. See, for example, *Smith v Bridgend County Borough Council* [2001] UKHL 58 at [36] where Lord Hoffmann, rejecting on the facts the existence of an equitable set-off, said: "In my opinion a defendant could not, in the absence of a lien or other security, claim to retain an asset belonging to a plaintiff by way of set-off against a monetary cross-claim. If this were not the case, everyone would in effect have a lien over any property of his debtor which happened to be in his possession."

[4] This working paper has been prepared as part of more extensive research for the forthcoming third edition of McCracken, 'The Banker's Remedy of Set-Off', to be published by Bloomsbury Professional, London in 2010. The second edition was published by Butterworths, London in 1998.

[5] See eg Wood, *Set-Off and Netting, Derivatives, Clearing Systems* (Thomson, Sweet & Maxwell London (2nd ed 2007) p 5; Goode, *Legal Problems of Credit and Security* (Thomson, Sweet & Maxwell London (3rd ed 2003) pp 13-14; Derham, *The Law of Set-Off*, Oxford University Press (3rd ed 2003) pp 762-774.

Having illustrated the issue by reference to a typical scenario, the paper then reviews the extent of current perceptions of set-off as security and examines the consequences of the differing interpretations for any technical classification of it as a security. It contends that such classification only becomes relevant if one particular interpretation prevails.

It is, however, not only set-off's role as a security that is impacted by the existence of different interpretations. Also potentially affected are third parties claiming rights over the debt forming the object of the set-off, who are commonly described as 'interveners'. The final section of the paper therefore explores by way of example one category of potential interveners; namely, secured creditors.

Analysis in this paper is focused primarily at a conceptual level. It is assumed for the purposes of the analysis that the relevant claims sought to be set-off fall within the recognised legal criteria and hence are capable of forming the object of a set-off. Further, discussion of the case law is confined to several key authorities. As is so often the position in any discussion of set-off, it is critical to focus initially on 'the fundamentals'[6] before delving into the extensive, and at times regrettably complex, case law.

2. Differing interpretations of the 'mechanism' of set-off

It seems quite extraordinary that the concept of set-off has no universally agreed meaning under Anglo-Australian law, given that the concept in one form or another has been recognised since at least the 17th century.[7] It is true that the actual result of a set-off is clear; namely, that only the net balance of two pecuniary claims is payable. In the recent decision of *Lindholm, Re Opes Prime Stockbroking Ltd* (2008) 68 ACSR 88 at 91 the Federal Court of Australia succinctly described an exercise of set-off in insolvency in just such terms. It said, quite simply:

> The amount due by one to the other is set-off against the debt due by that other and only the difference can be claimed.

It is, however, the means or 'mechanism' by which that outcome is produced which is far less clear. The range of explanations can be illustrated by considering the common situation where a customer has a deposit with a bank. Suppose, for the purposes of the example, that the customer has deposited $500 with the bank in one account, but is overdrawn by $300 on another account. On the exercise of a set-off, the bank owes the customer only $200. It is not difficult to identify the net amount. The problem lies in the fact that there are at least three ways in which, at a conceptual level, that exercise of the set-off by the bank may be explained:

- as a mechanical calculation;
- as an appropriation of property; or
- as a discharge of an obligation to make payment.

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[6] Posing the question whether set-off could be a security in law, Goode comments: 'We can answer this question only by going back to fundamentals': Goode, *Legal Problems of Credit and Security,* op cit p 13.

[7] See McCracken, *The Banker's Remedy of Set-Off,* op cit Ch 2 ,'An historical viewpoint'.

If the set-off operates by way of a mechanical calculation, the set-off is achieved simply by deducting the lesser sum (300) from the greater sum (500). If, however, set-off operates by way of an appropriation, part of the 500 (namely, 300) is applied to pay the outstanding 300 (or, more questionably, the 300 is used to pay part of the 500). In contrast to both these explanations, if set-off operates by way of a discharge, the original obligation on the part of the bank to pay 500 is discharged to the extent of the 300. These are clearly three very different processes for arriving at the same conclusion that 200 is owed by the bank; yet examples of all three can be found discussed under the heading of a 'set-off' in the cases and in the textbooks as well as being represented in a variety of clauses in commercial contracts.

In considering these processes, there is one further complicating fact that has to be taken into account; the fact that set-off can arise from a number of different sources. At a conceptual level, it might not unreasonably be expected that set-off should have the same meaning and should operate in the same manner irrespective of its source. In practice, however, this has not necessarily proved to be the case.

- Firstly, it has been traditional to distinguish between the different sources of set-off and to draw the conclusion that different rationales form the basis for each type of set-off, resulting in set-off potentially operating differently according to its type. [8] This make the matter complex as there are a variety of sources. Where parties are solvent, there are three sources. These are statute, equity and contract. Where one or both parties are insolvent, the primary - and in fact in most instances exclusive[9] - source is statute. Confusingly, statutory set-off in insolvency arises under different legislation[10] to statutory set-off pre-insolvency. [11]
- Secondly, the fact that set-off can be created by contract has meant that the boundaries of the concept have sometimes been 'pushed' by the particular interpretation of those drafting the contract. The operation of contractual set-off has arguably been a significant cause of some of the confusion over the actual concept.

While acknowledging both these factors, this paper focuses on simply one issue: the potential consequences of the differing interpretations of set-off for *its treatment as a security.*[12] While the writer's current research explores in depth the argument that set-off should operate simply as a discharge of a personal obligation irrespective of its

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[8] It can be argued that these different types of set-off have more in common than is often appreciated and may indeed share some common basis: see McCracken, *The Banker's Remedy of Set-Off* op cit p 61.

[9] While it is generally considered to be the exclusive form of set-off as between the original mutual debtors and creditors, the position may be different once a third party is involved: see discussion in section 4.

[10] *Corporations Act* 2001 (Cth) s 553C; *Bankruptcy Act* 1966 s 86.

[11] State legislation which currently exists in all States other than Queensland, is derived from the old English *Statutes of Set-Off* 1729 and 1735. See generally Derham, *The Law of Set-Off*, op cit Ch 2 at pp 36-43. In New South Wales, the previous statutory right pre-insolvency which was seemingly inadvertently abolished in 1969 was reintroduced under the *Civil Procedure Act* 2005 (NSW) s 21. For the background, see Law Reform Commission (NSW), *Set-Off*, Report No 94 (2000).

[12] The different interpretations have repercussions for the analysis of other issues. They may, for example, open for debate the conclusion by the House of Lords in *Stein v Blake* [1995] 2 All ER 961 that on insolvency both claims are extinguished and replaced by a new claim for the net balance.

specific source, the purpose of this paper is restricted to examining the *consequences* of the differing views.

3. Set-off as a 'security'

Historically, a very clear line divided the concept of set-off and that of security. In, for example, the 19th century case of *ex parte Caldicott* (1884) 25 Ch D 716 the Lord Chancellor, the Earl of Selborne, drew a firm distinction between principles applying to securities and those applying to 'mutual credits'. The notion of set-off as a security thus seems to be a modern phenomenon.

The interesting question is, however, the extent to which current perceptions of set-off as a security do in fact support a general view that set-off confers a security in the strict sense of conferring a proprietary or possessory interest. An examination of case law suggests that the term 'security' is often used rather loosely by the courts. Furthermore, at least one interpretation given to the mechanism by which set-off operates would indicate that set-off is simply *incapable* of functioning as a security in that strict sense.

(a) Perceptions of set-off as a security

Modern perception of set-off as some form of security has been traced by one commentator to the 1960s and 1970s. In the introduction to a book entitled *Using Set-Off as Security,* Neate noted that legal problems relating to set-off emerged during that period in cross-border financing transactions where parallel loans were used and subsequently in currency swaps which replaced the use of parallel loans in the late 1970s.[13] He concluded[14] that:

> The phenomenal growth of the swap market is but one example of the increasing demand in the financial industry for legal mechanisms whereby one person's obligation to pay money can be 'secured' by being offset against the counterparty's obligation to pay an equivalent sum of money, in the same or another currency.

Current views of set-off as security seem to stem primarily from several leading English cases in the 1980s/1990s and from commercial documents now in use in financial markets.

<u>(i) Judicial views</u>

Some evidence of a judicial perception of set-off as security can be found, for example, in the judgment of Millett J (as he then was) in 1986 in *Re Charge Card Services Ltd* [1986] 3 All ER 289 at 309. After denying that a creditor could take a

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[13] Neate (ed), *Using Set-Off as Security*, Graham & Trotman and International Bar Association, London 1990 pp 1-3.

[14] Neate (ed), *Using Set-Off as Security*, op cit, pp 2-3.

charge over a debt which it itself owed,[15] Millett J commented that that it did not follow that an attempt to create a mortgage or a charge of such a debt would be 'ineffective to create a security' and proceeded to discuss set-off. However, the context makes clear that he was using the term 'security' in a very general sense to mean a right which was effective in a liquidation.

In 1995 in *Stein v Blake* [1995] 2 All ER 961 at 964 Lord Hoffmann, delivering the unanimous judgment of the House of Lords, described the use by a bankrupt of his 'indebtedness to the bankrupt' as a 'form of security'. Once again, however, it can be argued that the court had in mind a broader notion of the term security as the concept was explained by reference to the creditor exercising the set-off having only to pay the net balance rather than as an interest in property. Nonetheless, the notion of set-off as security was taken up in the subsequent House of Lords decision in *Re Bank of Credit and Commerce International SA (No 8)* [1997] 4 All ER 568 at 573. Noting, in accordance with *Stein v Blake*, that the impact of a set off is to render the net balance payable, Lord Hoffmann stated :

> The effect is to allow the debt which the insolvent company owes to the creditor to be *used as security for its debt* to him. The creditor is exposed to insolvency risk only for the net balance.

In this context, it is also noteworthy that Lord Hoffmann expressed himself (at 576, 577) to be in agreement with the view of the Court of Appeal that both contractual and insolvency set-off could be regarded as 'effective security', while disagreeing (at 577) with the latter's view on the different point that a charge back was conceptually impossible.[16]

While these dicta may well suggest that the description of set-off as security is to be understood in its more general sense of additional comfort rather than proprietary interest, there is a further interesting statement by Lord Hoffmann in *Stein v Blake* [1995] 2 All ER 961 at 964, which throws into question the extent to which set-off should be regarded even in loose terms as a security. In describing insolvency set-off as a 'form of security', he explicitly referred to the underlying purpose of insolvency set-off and to the oft cited dictum of Parke B in *Forster v Wilson* (1843) 12 M & W 191 at 204; 152 ER 1165 at 1171. He said the following:

> Bankruptcy set-off….affects the substantive right of the parties by enabling the bankrupt's creditor to use his indebtedness to the bankrupt as a form of security. Instead of having to prove with other creditors for the whole of his debt in the bankruptcy, he can set off pound for pound what he owes the bankrupt and prove for or pay only the balance. So in *Forster v Wilson*….Parke B said that the *purpose of insolvency set-off was to do substantial justice between the parties*…. . (emphasis added)

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[15] In *Re Bank of Credit and Commerce International SA* (No 8) [1997] 4 All ER 568 at 575-578 the House of Lords disagreed with this view on the validity of the charge. It recognised that such a charge could be taken. The validity of such a charge remains a controversial issue in Australia, as noted below.

[16] 'The Court of Appeal said that the bank could obtain effective security in other ways [other than through a charge]. If the deposit was made by the principal debtor, it could rely upon contractual rights of set-off or combining accounts or rules of bankruptcy set-off under provisions such as r.4.90….All this is true. It may well be that the security provided in these ways will in most cases be just as good as that provided by a proprietary interest. But that seems to be no reason for preventing banks and their customers from creating charges over deposits if, for reasons of their own, they want to do so.' *Re Bank of Credit and Commerce International SA (No 8)* [1997] 4 All ER 568 at 577-578.

Care is required in considering this statement. This phrase attributed to Parke B is in fact in an abbreviated form. The full quotation makes clear that Parke B was not referring to some general notion of justice underlying the set-off, as the abbreviated phrase might infer, but rather to a much more limited notion. The full quotation is:

> ..to do substantial justice between the parties, *where a debt is really due from the bankrupt to the debtor to his estate*. (emphasis added)

This full quotation would, it is submitted, support an argument that insolvency set-off reflects not a notion of security but rather a different idea – a 'justice' that flows from a debtor not having to pay a debt to a creditor who in fact is indebted to that debtor through some mutual dealings. Such a 'justice' runs in fact through the history of set-off, particularly in insolvency, and explains for example the rationale for the criterion of mutual dealings in insolvency dealings as well as the consequential rule that claims of third parties are not available for the exercise of a set-off. As the Court of Appeal subsequently explained in *Re Bank of Credit and Commerce International SA (No 8)* [1996] 2 All ER 121 at 141:[17]

> There is no injustice in requiring a creditor against whom no claim is made to prove for the debt which is due to him.

Yet, the notion of set-off as security is arguably becoming entrenched. In 2008 in *Lindholm, Re Opes Prime Stockbroking Ltd* (2008) 68 ASCR 88 at 91 the Federal Court of Australia explicitly used the description of set-off as security. Interestingly, it noted both its use in a general commercial sense as well seemingly[18] as in the more technical sense.

This brief overview of the cases does, however, raise for debate the extent to which the cases can be taken as authority for the proposition that set-off is a security interest. While the term 'security' is certainly used, it is submitted that an examination of the actual statements suggests that the term is used for the most part very loosely to refer to the availability of some form of protection. Hence it is necessary to look elsewhere for support for an argument that set-off involves the creation of a security interest.

(ii) Commercial documentation

Evidence of a more explicit link between set-off and a security interest can be found in commercial documents typically in use in Australian financial markets. Examples are provided by some forms of negative pledges which imply that set-off is to be treated as a security interest and in actual contractual set-off clauses in loan documentation which use the language of appropriation and thereby may be interpreted as charges.

A negative pledge typically includes a prohibition on creating 'Security' and permitting 'Security' to exist, 'Security' usually being defined for these purposes as

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[17] A similar notion of justice can also be argued to underlie set-off in equity and indeed other forms of set-off, although such an argument is controversial. See McCracken, *The Banker's Remedy of Set-Off,* op cit, Ch 2.

[18] The court specifically stated that set-off had been called a security interest and cited Lord Hoffmann in *Stein v Blake* [1996] AC 243 at 251; 2 All ER 941 at 964. Neither report , however, appears (at least in the online version) to record this phrase. Lord Hoffmann is reported only as having described it as a 'form of security' (as to the meaning of which, see discussion in section 3).

including not simply the security interests of mortgages, charges and pledges but also arrangements having a similar effect. This general prohibition is often supplemented by a more specific prohibition under which persons are precluded from entering into arrangements under which money or the benefit of an account may be set off. That gives rise to an inference that a set-off falls within the scope of a Security and is on a par with a security interest. That inference is further strengthened by the fact that such a negative pledge would also typically contain a clause expressly excluding certain types of set-off arrangements such as those made in the ordinary course of banking arrangements for purposes of netting debit and credit balances. Such an exclusion implies that other forms of set-off arrangements are to be regarded as within the term, Security.

Sometimes less explicit but nonetheless always of considerable interest is the set-off clause itself. Its content obviously depends on individual drafting. Where the draftsperson uses the language of appropriation in stating, for example, that funds are to be applied by way of set-off, it is arguable that such language expressly creates a particular type of security interest, namely a charge.[19] Furthermore, where the draftsperson chooses not to explain how the set-off actually operates but simply states that the debts are to be set-off, there is a risk that it too could be a charge to the extent that that wording is interpreted as an act of appropriation (a risk which is discussed below).

There is unfortunately, but perhaps not surprisingly, no published history of the drafting of set-off clauses showing the language of the clause over the years. It may be speculated, however, that the modern draftsperson's selection of the words to describe the process of set-off may well have been influenced over the last ten years or so in the context of security by an *obiter dictum* of the English Court of Appeal in *Re Bank of Credit and Commerce International SA (No 8)* [1996] 2 All ER 121 at 132. Discussing the mechanism by which it was then contended that a charge could be taken over a debt owed by oneself, Rose LJ who delivered the unanimous judgment of the court commented:[20]

> It is said that some legal mechanism must be involved. That is true; the mechanism is that of set-off. This process can be variously described, but a debtor's *right to appropriate a debt which he owes to his creditor and apply it in reduction or discharge of a debt which is owed to himself* whether by the creditor or a third party is in our opinion accurately described as a right of set-off.

Such language is, however, akin to that of a charge.

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[19] See, for example, *National Provincial and Union Bank of England v Charnley* [1924] 1 KB 431 at 449-450; *Re Charge Card Services Ltd* [1986] 3 All ER 289 at 309; and, more recently, *Beconwood Securities Pty Ltd v Australia and New Zealand Banking Group Ltd* [2008] FCA 594 at [38]: 'A charge differs from a mortgage because it does not depend upon a transfer of the ownership of the charged property. It is of the essence of a charge that a particular asset or class of assets is appropriated to the satisfaction of a debt or other obligation of the chargor, or a third party, so that the chargee is entitled to look to the asset and its proceeds for the discharge of the liability: *Re Cosslett* [1998] Ch D at 508.'

[20] While the House of Lords overruled the Court of Appeal on its stance that such a charge was conceptually impossible, it made no comment on this definition of set-off: *Re Bank of Credit and Commerce International SA (No 8)* [1997] 4 All ER 568.

(b) ***Can set-off conceptually be a security?***

Whether a right has a security character is said to be a question of law and not the intention of the parties. [21]

The general schema of security interests is well established,[22] being constituted by those arrangements which offer some form of proprietary or possessory interest in another person's property (mortgage, charge, pledge and lien). In addition, it is not uncommon to include within a broader more commercial concept of security contractual arrangements which provide some additional level of comfort through the creation of an additional promise. Such a promise is generally taken from a third party (eg a guarantee or an indemnity) but may sometimes be taken from the debtor itself (eg a negative pledge).

Where in such a schema does set-off sit? The answer, it is submitted, depends quite simply on whether set-off is interpreted as a discharge of an obligation or as an appropriation of property.

Set-off, in so far as it operates as a discharge of a personal obligation to make payment, simply cannot be a security interest. In enabling a financial institution, for example, to claim that it no longer has to make payment by reason of the fact that its corporate counterparty owes it money, the set-off does not purport to create rights over that counterparty's property. Accordingly, it is submitted, it is only if set-off is viewed in terms of some form of appropriation of property, that the possibility of a true security interest becomes relevant.

Unfortunately, however, it is difficult to draw any firm conclusion from the case law as to how in the context of security the courts view the process of set-off operating.

Examples of both viewpoints – discharge and appropriation- can be found. On the one hand, as noted above, the Court of Appeal in *Re Bank of Credit and Commerce International SA (No 8)* was very clear in its description of a set-off as an appropriation. It was not the first time that such language was used. In 1993 in *MS Fashions Ltd v Bank of Credit and Commerce International SA (in liq) (No 2)* [1993] 3 All ER 769 at 785 Dillon LJ in the Court of Appeal, with whom Nolan and Steyn LL J agreed, appeared also to speak in terms of appropriation of the debt, concluding that the documentation at issue enabled the deposit of a third party who had accepted liability as a personal debtor to be 'appropriated without further notice'.

On the other hand, such statements can be contrasted with the description by Millett J in *Re Charge Card Services Ltd* [1986] 3 All ER 289 at 309:

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[21] See eg *Smith v Bridgend County Borough Council* [2001] UKHL 58 at [53], citing *Agnew v Commissioner of Inland Revenue* [2001] 3 WLR 454, 465-466 per Lord Millett.

[22] It will, however, change if the proposed Personal Property Securities Reform legislation is enacted. For the current state of reform proposals and the *Personal Property Securities Bill 2009*, see www.ag.gov.au under 'Consultations Reforms Reviews' and then 'Personal Property Securities Reform'.

> The debtor cannot, and does not need to, resort to the creditor's claim against him in order to obtain the benefit of the security; his own liability to the creditor is automatically discharged or reduced.

Sometimes, however, it is simply not clear how the set-off is understood to work. Lord Hoffmann's description in *Stein v Blake* [1995] 2 All ER 961 at 964, for example, is ambiguous.

> Bankruptcy set-off …affects the substantive rights of the parties by enabling the bankrupt's creditor to *use his indebtedness to the bankrupt as a form of security*. Instead of having to prove with other creditors for the whole of his debt in the bankruptcy, he can set off pound for pound what he owes the bankrupt and prove for or pay only the balance.

The indebtedness of the creditor to the bankrupt (the amount that the creditor owes) is obviously the asset of the bankrupt. It is not clear from this passage as to precisely how the creditor uses it – is the creditor, for example, appropriating that property?

This notion of this 'use of a claim' is found again in *Re Bank of Credit and Commerce International SA (No 8)* [1997] 4 All ER 568 at 573 where Lord Hoffmann, delivering the unanimous judgment of the House of Lords, said:

> The effect is to allow the debt which the insolvent company owes to the creditor to be used as security for its debt to him.

This is somewhat confusing as it appears, on one reading at least, to suggest that a different asset is being used as security – namely, the debt owed by the insolvent person rather than the debt owed to the insolvent person. The distinction is important. The debt owed by the insolvent person is the creditor's asset while the debt owed to the insolvent person is that insolvent person's asset. While both may be described as a use (or appropriation) of property, it is only appropriation of the property of *another* which gives rise to a charge.

Wood has certainly argued that a creditor uses the debt owed to it, which is its asset, to pay off the other claim,[23] thereby distinguishing it from a charge. This has been criticised by Derham,[24] partly on the basis that the existence of the different types of set-off make it difficult to draw any general conclusion as to how set-off operates.[25] In considering the position on insolvency and in particular the fact that set-off operates automatically, Derham concludes:[26]

> ..that it is not profitable to consider which of the demands is set-against the other. They are simply brought together, by force of statute, into an account.

This writer would, however, agree with Wood that the analysis of the process of setting off is critical, although would disagree with the description given by Wood. Although Wood defines set-off more generally as the discharge of reciprocal obligations to the extent of the smaller obligation, he regards it as a form of payment.[27] This writer views it rather as a discharge of an obligation to make the payment.

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[23] Wood, *Set-off and Netting, Derivatives, Clearing Systems*, op cit pp 4, 10-13.
[24] Derham, *Law of Set-Off,* op cit, pp 766- 768.
[25] Derham, op cit p 767.
[26] Derham, op cit, p 767.
[27] Wood, op cit, p 4.

As noted previously, the danger in 'sliding into' the language of appropriation of another person's asset is the risk that a charge is created. As a result, what is intended to be a 'set-off arrangement' becomes at law a charge. Yet ironically those who draft the set-off using the language of appropriation would seem to distinguish it from a charge. They commonly expressly describe the clause as a 'set-off'.

This crossing of the line between set-off and charge has been noted by Goode,[28] who concludes that the recognition of the validity of the charge back arrangement by the House of Lords in *Re Bank of Credit and Commerce International SA (No 8)* [1997] 4 All ER 568 has caused the distinction between contractual set-off and security to become blurred as both are effected in the same way ie through book entry. He comments:[29]

> ..it seems the only way of distinguishing a charge over the debtor's obligation from a contractual set-off is by the label given to the agreement by the parties…

In England, the issue of whether set-off is a security appears to have become inextricably mixed up with the debate as to whether a charge can be taken over a debt owed by oneself. This has dogged the discussion for many years but it can be argued that it is a separate issue and that there is room in the debate for an intermediate position. Insofar as the contractual set-off is drafted explicitly as a charge, it is – and should be recognised as - a charge. However, the set-off can be drafted in different terms – namely, as a discharge from an obligation to make payment. In that case, contractual set-off has a distinct role to play.

The distinction between charge and contractual set-off, based on an interpretation of contractual set-off as a discharge from an obligation, is particularly important in Australia as a matter of practice, for two reasons:

- a charge over a deposit made with oneself has not been clearly recognised yet in Australia. The weight of authority is, however, still against recognition.[30]
- specific rules regulate the operation of a charge; for example,
    - a charge cannot generally be enforced in an administration without the written consent of the administrator or leave of the court;[31]
    - a charge may be registrable; [32]
    - priority rules apply either at common law or under the *Corporations Act* 2001 (Cth) to resolve the ranking of competing claims;
    - a charge may have remedies implied by statute (eg sale; receivership under State legislation such as the *Conveyancing Act* 1919 (NSW) s 109 and its State counterparts.[33]

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[28] Goode, *Legal Problems of Credit and Security,* op cit, p14.

[29] Goode, op cit, p 14.

[30] See *Broad v Commissioner of Stamp Duties* [1980] 2 NSWLR 40; *Estate Planning Associates (Australia) Pty Ltd v Commissioner of Stamp Duties* [1985] 2 NSWLR 495; *Esanda Finance Corporation v Jackson* (1993) 11 ACLC 138; *Wily v Rothschild Australia Ltd* (1999) 47 NSWLR 555. Cf *Cinema Plus Ltd v Australia and New Zealand Banking Group Ltd* (2000) 35 ACSR 1 at 6.

[31] *Corporations Act* 2001 (Cth) s 440B, subject to s 441A where the charge is over the 'whole, or substantially the whole, of the property'.

[32] *Corporations Act* 2001 (Cth) s 262.

[33] *Property Law Act* 1974 (Qld) s 83; *Law of Property Act* 1936 (SA) s 47; *Conveyancing and Law of Property Act* 1884 (Tas) s 21; *Property Law Act* 1958 (Vic) s 101; *Property Law Act* 1969 (WA) s 57.

Some discussion of the distinction between a contractual set-off and a charge arose in the decision in 2000 of the New South Wales Court of Appeal in *Cinema Plus Ltd v Australia and New Zealand Banking Group* Ltd (2000) 35 ACSR 1. However, the issue was not clear cut. While the court concluded that a particular contractual clause – referred to by the court as a set-off clause – did not amount to a charge, the court did not clearly distinguish between the right of combination and the right of set-off. This is a further 'grey area' as the right of combination is often regarded as a type of set-off, although this writer would disagree with that view.[34]

The relevant clause, under the heading of 'Consolidation of Accounts' stated:

> We may at any time combine, consolidate, merge or apply any credit balance in any of your accounts, or any amount available to us by way of set-of[sic], lien or counterclaim, towards payment of money which is then, or will become, due and payable by you to us under any transaction document.

Leaving aside the conceptual issue of whether a charge can be taken over the debt which the chargee owes, the New South Wales Court of Appeal found that this specific wording did not give rise to a charge but rather to a contractual right. Spigelman CJ said (at [46]):

> Clause 21 does not manifest an intention to make available the company's property in an account as security for the company's obligations. There was no deposit specifically made by the customer for purposes of security. There was no obligation to maintain any account. There were no restrictions on the conduct of any account. Nor was any account, or indeed the body of accounts as they may exist from time to time, appropriated in any way, either immediately or contingently, as security for any present or future debt.
>
> The cumulative effect of these aspects of cl 21 leads to the conclusion that cl 21 creates a contractual right. It does not, in my opinion, constitute a charge.

Sheller JA and Giles JA agreed that it was not a charge.

Spigelman CJ explained the effect of the arrangement as follows:

> In my opinion, cl 21 is, in effect, a contractual right to 'seize' an account in the future. ..It does not manifest an intention on the part of the parties to create any form of present right over property of the company. It confers a *right to take steps in the future, which have the consequence that the company's chose in action will be extinguished in whole or in part*. (emphasis added)

Two further general observations may be made in relation to the debate over whether set-off may be a charge, stemming from the factual situations in which the discussion of security has taken place.

- it is not surprising to find the discussion of security and/or the language of appropriation in cases such as *MS Fashions Ltd v Bank of Credit and Commerce International SA (in liq) (No 2)* [1993] 3 All ER 769 and *Re Bank*

[34] See McCracken, *The Banker's Remedy of Set-Off*, op cit, Ch 1.

of Credit and Commerce International SA (No 8) [1997] 4 All ER 568. Both these cases involved a deposit. Claims to set-off against deposits are often expressly established by contract and it is not difficult to see how any rights in relation to that deposit could be characterised as some form of security. There is a natural, albeit mistaken, tendency to picture a deposit as a 'bag of money' rather than as the ledger entry required by *Foley v Hill* (1848) 2 HL Cas 28; 9 ER 1002.[35]

- For that reason, it is interesting to find the description 'security' appearing in *Stein v Blake* [1995] 2 All ER 961 where the claims at issue did not involve a deposit but were claims for breach of contract and for misrepresentation. *Stein v Blake* was not a situation where the parties had negotiated for security. Lord Hoffmann's remark in fact was part of a general description of the history and purpose of insolvency set-off, rather than specifically directed at these two claims. Neither party, it is submitted, would have seen their claim as a form of security.

Finally, in discussing the nature of set-off in *Broad v Commissioner of Stamp Duties* [1980] 2 NSWLR 40 at 44 Lee J described 'security' as having a wide meaning of 'something which makes the enjoyment or enforcement of a right more secure or certain'[36] and noted (at 48) that set-off might be able to be included within this wide description of the term. However, it is very doubtful, in this writer's view, whether it is useful to think of set-off in terms of a security. In the first place, it does not resemble those contractual promises which traditionally have been regarded as security in the broader sense, such as the guarantee. It is not a promise by a person (debtor or third party) to do or not do some action, in particular pay money or forebear from creating security. Rather, the set-off is directed at ensuring that a person does not have to pay out when in overall terms, through the mutuality of the dealings or the relationship of the claims, the person does not owe that full amount.

Perhaps this modern tendency to view set-off as security can be attributed to a perception that it changes the *pari passu* rule. In *Lindholm, Re Opes Prime Stockbroking Ltd* (2008) 68 ACSR 88 at 91, for example, Finkelsein J described set-off as 'a significant encroachment upon the pari passu rule'. A similar view is evident from Lord Hoffmann's explanation as to why insolvency set-off is limited to mutual dealings in *Re Bank of Credit and Commerce International SA (No 8)* [1997] 4 All ER 568 at 573:

> There can be no set-off of claims by third parties, even with their consent. To do so would be to allow parties by agreement to subvert the fundamental principle of pari passu distribution of the insolvent company's assets... .[37]

It is however submitted that when set-off's purpose is viewed as ensuring that a person does not have to make payment when it itself is owed an amount and particularly where set-off's operation is interpreted as discharging a person from an obligation to make payment, little is added to the general understanding of the concept

[35] This decision made clear that money deposited by a customer with the bank becomes the money of the bank. The customer's asset becomes the debt then owed by the bank to the customer, given that the bank '..has contracted, having received that money, to repay to the principal, when demanded, a sum equivalent to that paid into his hands.': *Foley v Hill* (1848) 2 HL Cas 28 at 36; 9 ER 1002 at 1005.
[36] He cited Jowitt's *Dictionary of English Law*.
[37] He cited *British Eagle International Airlines Ltd v Cie Nationale Air France* [1975] 2 All ER 390.

by describing it as a security device. Indeed that appellation rather risks adding confusion to the discussion of set-off. In this context, it is interesting to note that the *Personal Property Securities Bill 2009* expressly excludes 'any right of set-off or right of combination of accounts' from the operation of the Act.[38]

Rejecting the notion that set off is some form of security does not, however, mean that set-off is not relevant to a discussion on security. Quite the opposite is true. It is highly relevant, both pre-insolvency and on bankruptcy or liquidation itself, insofar as the set-off may impact on the rights of those who claim to be secured over the debt sought to be set-off.

4. Rights of interveners, such as secured creditors

What happens if a third party (often described by commentators as an 'intervener') makes a claim on the debt owned by the original creditor (C1) which would otherwise be the object of the set-off? There may be a number of reasons for that intervention. In the context of a discussion of security, the following two scenarios are not improbable:[39]

- the debt owing to C1 is *mortgaged* by C1 to another person (C2);
- the debt owing to C1 is *charged* by C1 to C2.

In such circumstances, should that intervening creditor, C2, be able to take the debt free of any claim of set-off by the debtor (D)? Or can D claim to exercise the set-off against C2? During the life of the debt, this is a major risk for D. The debt that was to form the object of the set-off may no longer be available for that purpose. Is that a risk that should be borne by D? (While this Conference Session focuses on the position on liquidation, that position depends to an important extent on the position pre-insolvency, for reasons explained below.)

At a conceptual level, it is submitted that the reaction of D to an intervention will be influenced by how the set-off is understood and debtors and creditors may well hold very different views depending on whether they see the set-off as a means of discharge of an obligation or as an appropriation of property.

Those who view the set-off as an appropriation could be expected to argue that D has rights over the debt and that D should have a stronger right to that debt than C2. By contrast, those who regard set-off as a discharge of an obligation might logically argue that the intervention of C2 means that D is no longer in a situation where there are mutual or related dealings between D and C1 which could give rise to a set-off. Such an interpretation does not of course mean that they are not concerned about the

[38] *Personal Property Securities Bill 2009* s 8(1)(d). See also s 8(1)(e) for exclusions of rights and interests held under netting arrangements under the *Payment Systems and Netting Act* 1998 (Cth).

[39] For other examples of interveners, see generally Wood, *Set-Off and Netting, Derivatives, Clearing Systems*, op cit Ch 5. In Australia, a further interesting question beyond the scope of this paper is raised *by Banking Act* 1959 (Cth) s 13(A)(3) which sets out priorities for the application of assets of ADIs in Australia where the ADI is unable to meet its obligations or suspends payment.

loss of a right of set-off. Rather, they acknowledge that a set-off logically might be lost and that therefore D must take other means to protect its position; for example, by attempting to preclude any dealings with the debt by C1 and C2.[40] Nonetheless, it is also conceivable that they could alternatively argue that D should remain able to be discharged from its obligation to make payment, given the particular nature and interrelationship of the competing claims. Both are plausible.

These conceptual arguments are not necessarily reflected in the way the law actually operates in practice. When dealing with mortgages of a debt, the law draws on principles of assignment. The law in this area is not clear. Indeed, one commentator has described the relevant legal rules as '..both astonishingly complex and at times scandalously uncertain'. [41] Further, although not often discussed, there is an important issue as to whether the relevant rules relating to assignment actually apply whenever the intervener is secured by a fixed charge rather than a mortgage. Both English and Australian courts and indeed commentators have tended for the most part to assume that the assignment rules apply. If they do not apply, the outcome could differ depending on whether C2 holds a mortgage or a charge.

The issues are briefly outlined in the following scenarios. It is assumed in each case that the intervener claims a fixed security, such as a legal or equitable mortgage or a fixed charge. If the intervener simply has a floating charge, an exercise of a set-off pre- liquidation is not affected as the intervener cannot claim an interest in the debt until crystallisation.[42]

(i) Set-off viewed as an appropriation of the other party's asset and thus as a fixed charge

This is probably the easiest scenario to deal with, arising through the drafting of an express set-off clause which is phrased in terms of an appropriation of the other person's asset. It depends however on the courts being willing to recognise that a charge can arise over a debt owed by oneself, an issue that remains unresolved in Australia.[43]

If D argues that it has a charge over the debt owed by it by reason of having a right to exercise a set-off, its claim will be treated as any other priority issue. Assuming the validity and enforceability of the charge, the issue is whether the competing charges are both registrable. If so, the priority rules under the *Corporations Act* 2001 (Cth) will apply. If not, common law rules will apply. A critical point in that discussion will be the registrability of the D's charge over the debt; in particular, whether it is a book debt for the purposes of the *Corporations Act.*[44]

[40] The effectiveness of a prohibition on assignment is controversial: see generally Goode, *Legal Problems of Credit and Security,* op cit, pp 106-110.
[41] Tettenborn, ' Assignees, equities and cross-claims: principle and confusion' [2002] LMCLQ 485 at 485.
[42] *Biggerstaff v Rowatt's Wharf Ltd* [1896] 2 Ch 93.
[43] See discussion above.
[44] See McCracken, *The Banker's Remedy of Set-Off,* op cit, p 211.

(ii) Set-off viewed as a discharge of an obligation

As this discussion proceeds on the basis that set-off operates by way of discharge of an obligation to make payment, there is no longer a true priority issue as there are no competing claims over property.

It is necessary in the discussion to draw a distinction between the situation where the intervener has a mortgage and where it has a charge. It has been argued that there should be no distinction between these two positions,[45] but as a matter of law mortgages and charges give different rights and the position requires examination.

(a) Intervention through mortgage[46] of the debt by C1 to C2

Logically it may be argued that by C1 transferring to C2 the title of the debt owed by D, C1 has fundamentally altered the position by introducing a new person with a new claim over the debt.

C2 would certainly be keen to argue that it has obtained the title to that debt and as it does not owe any debt to D, it therefore has a right to payment in full. As noted above, D might conceptually at least accept the argument that there is no 'injustice' in the set-off sense as mutual debts are no longer owing between D and C1 and are not owing between D and C2. On this basis, D would not have a set-off against either C1 or C2.

Such an argument however ignores the rules that have developed relating to assignment of debts. There is a further principle that comes into play that impacts on the analysis – namely that the assignee should not be in a better position than the assignor (at least until notice of the assignment is received by the debtor).

The rule that originally developed in equity[47] and was subsequently adopted by statute is that the assignee takes subject to equities arising prior to the debtor receiving notice of the assignment. 'Equities' for these purposes includes a set-off (whether arising pre-insolvency under statute, by contract or in equity).[48] The classic description is that given by Templeman J in *Business Computers Ltd v Anglo-African Leasing Ltd* [1977] 2 All ER 741 at 748:

> The result of the relevant authorities is that a debt which accrues due before notice of an assignment is received, whether or not it is payable before that

[45] See Derham, *The Law of Set-Off,* op cit, p 832, noted below.
[46] For these purposes, the legal mortgage and equitable mortgage are treated in the same way as they both involve an assignment and the relevant legal and equitable rules relating to the equities to which an assignment takes subject are the same on this point, as discussed below.
[47] See explanation given by the Court of Appeal in *Pellas v Neptune Marine Insurance Co* [1874-1880] All ER Rep Ext 1509: 'Without the aid of the statute the assignee might have sued at law in the name of the assured, and in a court of equity in his own name. The statute was passed because the Legislature wished to give the assignee a more convenient remedy, and intended that he should be in the same position as if he sued in a court of equity; no alteration in the rights of the parties was contemplated…'.
[48] See generally Derham, *The Law of Set-Off*, op cit, pp 457-458, 805-811.

> date, or a debt which arises out of the same contract as that which gives rise to the assigned debt, or is closely connected with that contract, may be set-off against the assignee. But a debt which is neither accrued nor connected may not be set-off even though it arises from a contract made before the assignment.

If pre-insolvency, C2 takes subject to D's set-off against C1, what happens on insolvency? There is clearly no mutuality between D and C2 for the purposes of insolvency set-off. Nonetheless, an argument can be made on the basis of general principle that although insolvency set-off is usually described as the only operative source of set-off once the debtor goes into liquidation, the assignee should nonetheless take subject to equities to the same extent that it would pre-insolvency.

(b) Intervention through charge of the debt by C1 to C2

Assume that C2 takes a charge over the debt owed by D to C1. The question now is whether the effect of this intervention is to destroy mutuality between D and C1? If it is a fixed charge creating an immediate equitable interest, at a conceptual level the initial answer would seem logically to be yes. If it is a floating charge, mutuality will be potentially destroyed when the charge crystallises and the equitable interest is created. If mutuality between D and C1 is destroyed and if there are no grounds for C2 taking subject to any equities held by D, an intervener as chargee will be in a stronger position than if it was a mortgagee. D will have no set-off.

The position has generally been considered by the courts in the context of an appointment of a receiver under a charge. Interestingly, the courts have for the most part addressed the issue by expressly applying the rules relating to assignment, even though technically it can be argued that the creation of a fixed charge does not involve a transfer of title, but rather the creation of new rights over the property charged. There appears to be a policy view that C2 as chargee should not be in a stronger position than C1: *Business Computers Ltd v Anglo-African Leasing Ltd* [1977] 2 All ER 741. [49]

This conclusion is open to debate. It can be argued, for example, that it is not actually justified by s 12 of the *Conveyancing Act* 1919 (NSW), and its equivalent State counterparts,[50] which deal with:

> ... any absolute assignment by writing under the hand of the assignor (not purporting to be *by way of charge only*) of any debt…. .

This terminology clearly covers a mortgage which operates as a transfer of title, but it does not appear to cover a charge. The distinction between mortgage and charge for these purposes was clearly made in the 19th century in *Burlinson v Hall* (1884) 12 QBD 347. [51]

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[49] See also *Rother Iron Works Ltd v Canterbury Precision Engineers Ltd* [1974] QB 1 at 6 per Russell LJ; *George Barker (Transport) Ltd v Eynon* [1974] 1 WLR 462.

[50] *Property Law Act* 1974 (Qld) s 199; *Law of Property Act* 1936 (SA) s 15; *Conveyancing and Law of Property Act* 1884 (Tas) s 86; *Property Law Act* 1958 (Vic) s 134; *Property Law Act* 1969 (WA) s 20.

[51] This case was followed in *Tancred v Dalagoa Bay and East Africa Railway Co* (1889) 23 QBD 239, where the security in question was a mortgage rather than a charge.

In *Roadshow Entertainment Pty Ltd v (ACN 053 006 269) Pty Ltd* [1997] 42 NSWLR 462 at 482 the NSW Court of Appeal accepted[52] that on the crystallisation of a floating charge the relevant debts owed to the companies were caught by a fixed charge and they too explicitly described that fixed charge as operating:

> …as a completed equitable assignment to the secured creditors….

However, some contradictory dicta can be found. Authorities for and against the statement were considered more recently, for example, by the Queensland Supreme Court in the unreported decision of *Vangale Pty Ltd (in liq) v Kumagai Gumi Co Ltd* [2002] QSC 137. The court also noted criticism by academic commentators[53] describing the holding to that effect in *National Mutual Life Nominees Ltd v National Capital Development Commission* (1975) 37 FLR 404 as 'very debatable'.

As a result, the position on liquidation is unclear. There is no mutuality between D and C1, nor between D and C2. However, C2 may take subject to D's claim if the charge is treated as an assignment, but not otherwise.

Derham argues that the distinction between a mortgage and a charge should not be critical.[54] The point is important, particularly given the extent to which a debtor can protect itself. While admittedly the position on assignment is not free from doubt, the current view appears to be that a prohibition on assignment will prevent C1 from assigning the debt owed to it to C2. However, a prohibition on creating a charge, which is in substance a negative pledge, is likely on breach to result only in damages or, if equity will assist in the circumstances, receivership. It does not prevent the creation of the interest in favour of C2.

The complexity of the arguments highlights the benefits in these circumstances of the alternative view that set-off operates as an appropriation of the property. If, however, the view is taken that set-off can only operate as a discharge from an obligation, which is this writer's view, there is no alternative but to attempt to address that complexity.

5. Conclusion

Although commercially financial institutions and others may consider themselves protected by having the power to exercise a set-off in relation to mutual dealings, the only conclusion that can be drawn is that the extent of their protection is unfortunately far from clear. Any suggestion that a set-off confers some form of security must be carefully considered. On current authority, judicial characterisation of set-off as a security should not be understood as indicating the existence of some proprietary interest. It is only if set-off can legitimately be interpreted as operating as an appropriation of property, that it may amount to a security in the form of a charge. If, however, set-off is interpreted as functioning as a discharge from an obligation to make payment, it cannot amount to a charge. For as long as both these competing views of set-off's operation persist, differing opinions as to whether set-off should be regarded as a security will inevitably be held. This means uncertainty not simply as

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[52] *Re ELS Ltd* [1995] Ch 11 is cited as authority.

[53] Sykes & Walker, *The Law of Securities*, Law Book Co Sydney 5th ed 1993 at p 960.

[54] See, for example, Derham, *Set-Off,* op cit, p 832.

between the two immediate parties to the set-off but also potentially vis-à-vis interveners such as secured creditors. The position of those interveners is further complicated by the interplay of technical rules relating to assignment of debts and by the doubts over the application of these latter rules to charges.

One final observation. As a matter of practice, it is likely that it is only the person seeking to exercise the set-off that will tend to view the arrangement as a 'security'. Those against whom the set-off is sought may hold a very different view. This has been well illustrated recently in the retail banking sector in the UK where banks are reportedly using their powers of set-off as a means of recovering debts owed to them. The English newspaper, The Observer, ran the following headline on Sunday 28 June 2009 'Banks exploiting obscure law to raid accounts and recover debts', summarising the issue as 'Secretive practice of 'setting off' sees savings and even benefit payments being snatched from customers'. It noted that in extreme cases customers were left 'unable to pay basic bills or buy food'. Bank customers are reported to be outraged. According to The Observer, their claims have been referred to the Financial Ombudsman Service and the matter is now under investigation by the Banking Code Standards Board. It would indeed seem implausible that these customers would regard their banks as having a legitimate security device.

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31 July -1 August 2009

Set-off as a security device

Jason Boyes
Partner
Buddle Findlay
Wellington

Set-off as security

(Jason Boyes)

(July 2009)

BUDDLEFINDLAY

Introduction

- Some types of set-off as security
  - Combination and contractual set-off rights
  - Set-off in insolvency
- Priority of bank's right to combine or set-off a deposit
  - Application of the Personal Property Securities Act 1999 and the Companies Act 1993
- Some implications for collateral transfer arrangements (e.g. ISDA Credit Support Annex)

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Some types of set-off as security

- A has a deposit of $100, and an overdraft of $50, with Bank X
  - Bank's rights of combination
  - Contractual set-off rights (set-off provision or separate deed, Deed of Set-off and Charge)
  - Statutory and equitable set-off rights
- Close-out netting provisions (e.g. ISDA Master Agreement)
- Collateral transfer arrangements (e.g. ISDA Credit Support Annex)

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Insolvency set-off

- A owes B $10, B owes A $5, B in liquidation
  - With set-off, A pays $5
  - Without set-off, A pays $10 and proves for $5 in liquidation. If only receives $0.50 in the dollar ($2.50), has effectively paid $7.50 instead of $5
- Liquidation
  - Mandatory set-off of liquidated, mutual debts (section 310, Companies Act)
  - Overrides other set-off rights, except certain "netting agreements"

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Insolvency set-off

- Bilateral netting agreements
  - *An agreement that provides that, in respect of transactions between two persons to which the agreement applies…that amounts payable by each party to the other party are to be paid or satisfied by payment of the net amount of those obligations by the party having a net debit to the party having a net credit*
- Also covers close-out netting provisions
- Effective in liquidation (section 310C)
- Not limited to financial markets participants or transactions

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Insolvency set-off

- *Transotway Limited* v *Shepard* (2006)
- Section 310 set-off not available as (section 310(2))
  - Within 6 months of liquidation
  - Transotway did not prove it did not have reason to suspect Newman was insolvent
- In any event, arguably a “bilateral netting agreement” so voidable as reduced an amount owing at the time it was entered into

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Insolvency set-off

- Similar provisions apply in voluntary administration
- Receivership itself does not affect set-off rights
- Statutory management moratorium on set-off and netting
  - Does not apply to netting agreements

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Priority of set-off and security interests

- A has a deposit of $100, and an overdraft of $50, with Bank X. A has given a general security agreement ("**GSA**") to Bank Y securing a term loan of $100.
- The answer to two questions determine how the PPSA applies here
  - Is any right Bank X has to combine or set-off these accounts a "security interest"?
  - Is the deposit an "account receivable"?

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Is a set-off a security interest?

- A security interest is
  - An interest in personal property created or provided for by a transaction that in substance secures payment or performance of an obligation
- On its own, no
  - Bank X does not have a proprietary interest in A's right to be paid its deposit
  - Section 23(c) provides that the PPSA does not apply to rights of set-off (except section 102)
- In some circumstances though…

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Collateral transfer arrangements?

Security interest

- Recipient obtains a proprietary interest in the collateral
- The recipient's exposure is reduced
- In substance, the collateral provider's obligations have been secured
- Title is irrelevant, and an "assignment that secures" is a security interest

Not security interest

- Proprietary interest not the kind the PPSA intended to apply to, as recipient has no obligation to return the same collateral
- Is the set-off, not the proprietary interest, that secures the collateral provider's obligations
- Under section 23(c), PPSA does not apply to set-offs

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Is the deposit an account receivable?

- Account receivable is
  - *a monetary obligation that is not evidenced by chattel paper, an investment security, or by a negotiable instrument, whether or not that obligation has been earned by performance*
- Yes, but *CIR v Northshore Taverns Ltd* (2008)
  - Not all monetary obligations but only “book debts”
  - Should be possible to limit to Schedule 7 of the Companies Act (priority of security interests and preferential creditors)

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Section 102 of the PPSA

- Bank Y's rights to the deposit as a secured party subject to
  - Terms of the contract between the account debtor (Bank X) and the assignor (A) (section 102(1)(a))
  - Any defence or claim arising from the contract or a closely connected contract (section 102(1)(a))
  - Any rights of set-off (or other defence or claim) that accrues before Bank X knew of the assignment (i.e. Bank Y's GSA) (section 102(1)(b))

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Post-notice contractual set-offs

- Bank X also has contractual set-off rights, and after learning of Bank Y's advances a further $50 to A
- Do post-notice contractual set-offs rank ahead of Bank Y's GSA? (i.e. does 102(1)(a) or (b) apply?)
- No, or may be not, camp
  - Section 102(1)(a) was not intended to change common law
  - Section 102(1)(b) expressly refers to rights of set-off and 102(1)(a) does not
  - Bank X should take a security interest in the deposit, and register a financing statement, as well

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Post-notice contractual set-offs

- Yes, or may be, camp
  - Different views on the common law position on the priority of assignees and contractual set-offs
  - Section 102(1)(b) only expressly applies to “defences by way of right of set-off”, which contractual set-offs are not
  - The problem of section 310B(2) of the Companies Act.
- Section 310B(2) if A in liquidation
  - Requires netting of post-notice transactions between Bank X and A, which might ordinarily be precluded
  - If “no” camp correct, Bank X would still have to pay Bank Y

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When do set-off rights "accrue"?

- A has a deposit of $100, an overdraft of $50, and a term loan of $50 with Bank X when Bank X learns of Bank Y's GSA.
- Right to combine overdraft but not the term loan as "accrues" post-notice – statutory set-off the same
- Contractual set-off rights probably accrued (as long as term loan accelerated when Bank Y claims the deposit)
- Same result in liquidation

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Priority of set-off and proceeds security interests

- A buys inventory on credit from B, who takes a security interest over the inventory to secure the purchase price. A deposits the proceeds of the inventory with Bank X.
- B's security interest extends to the proceeds
- Under section 102(1)(b), B would rank ahead of Bank X's right to set-off advances to A, post-notice of B's security interest
- But…

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Priority of set-off and proceeds security interests

- Sections 94, 95 and 96 of the PPSA allow Bank X to take cash, cheques and debtor-initiated payments free of B's security interest
  - Cash, give value
  - Cheques, give value and did not know the particular cheque was proceeds
  - Debtor-initiated payment of an amount owed
  - Payment in reduction of overdraft would be covered
  - Payment into deposit account might be "value"
- Applies to collateral transfer arrangements also

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Sheraton Mirage Resort, Gold Coast

31 July -1 August 2009

Friday 31 July
1:30pm – 3:00pm

Capital raising by banks and other financial institutions following the credit crisis

(Panel presentation – no papers available)

Chair:
Angela Flannery
Partner, Clayton Utz, Sydney

Speakers:
Therese McCarthy-Hockey
Treasurer: Australia & New Zealand Deutsche Bank AG, Sydney

Jason Elphick
General Counsel - Capital & Funding, National Australia Bank, Melbourne

Ross Pennington
Partner, Russell McVeagh, Auckland

The 26th Annual Banking and Financial Services
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31 July -1 August 2009

Friday 31 July
1:30pm – 3:00pm

Privacy Law in Evolution: Across the Pacific

Chair:
Amanda Parshall
General Counsel, HSBC Bank Australia Ltd. Sydney

Speakers:
Karen Curtis
Australian Privacy Commissioner, Canberra

Marie Shroff
New Zealand Privacy Commissioner, Wellington

Katherine Forrest
Partner, Mallesons Stephen Jaques, Melbourne

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Privacy Law in Evolution: Across the Pacific

Karen Curtis
Australian Privacy Commissioner
Canberra

Australian Government
Office of the Privacy Commissioner

Privacy Law in Evolution: Across the Pacific

Crumble in the Jungle conference

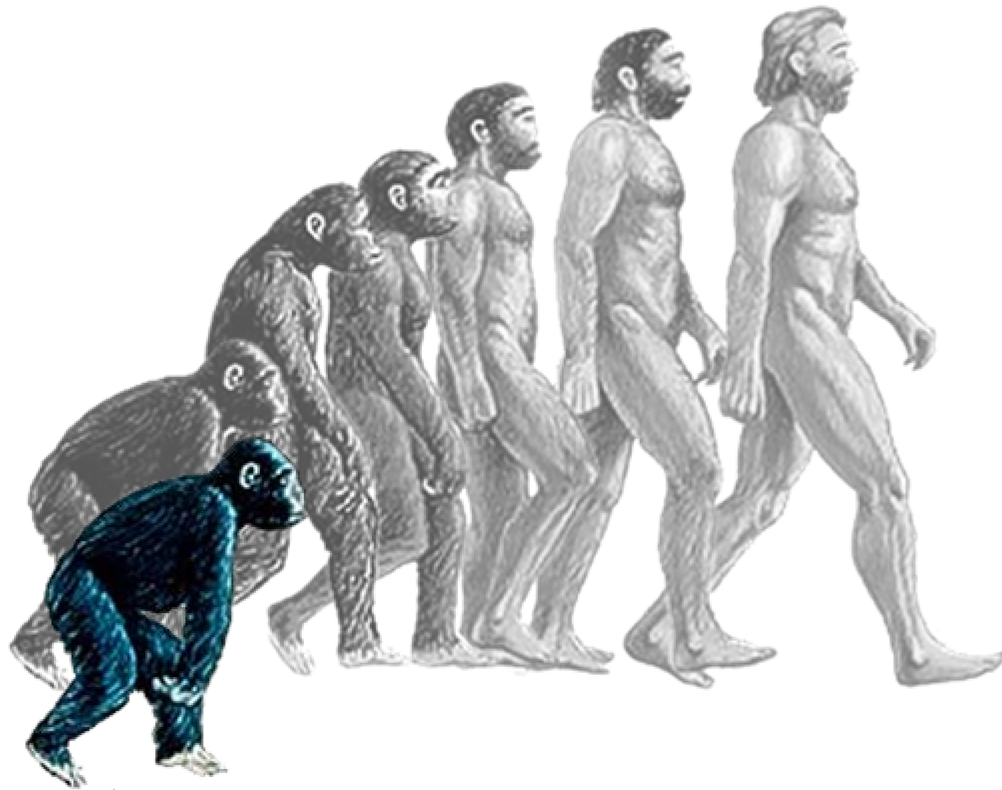
Karen Curtis
Australian Privacy Commissioner

Gold Coast

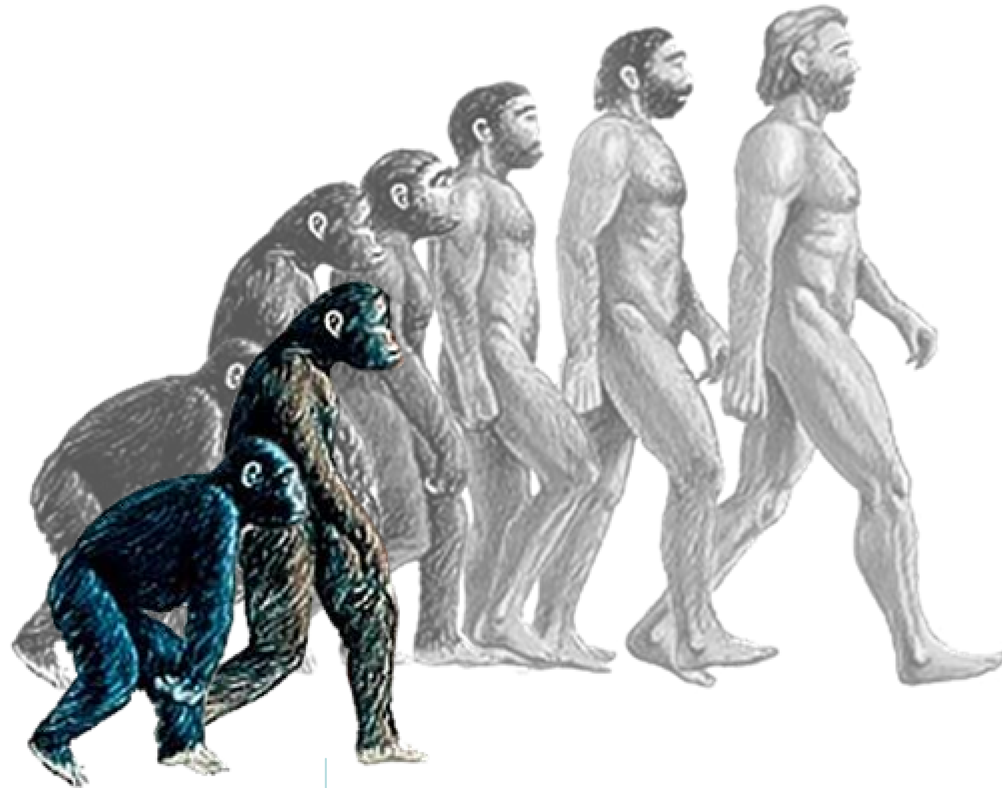
31 July 2009

Today's presentation

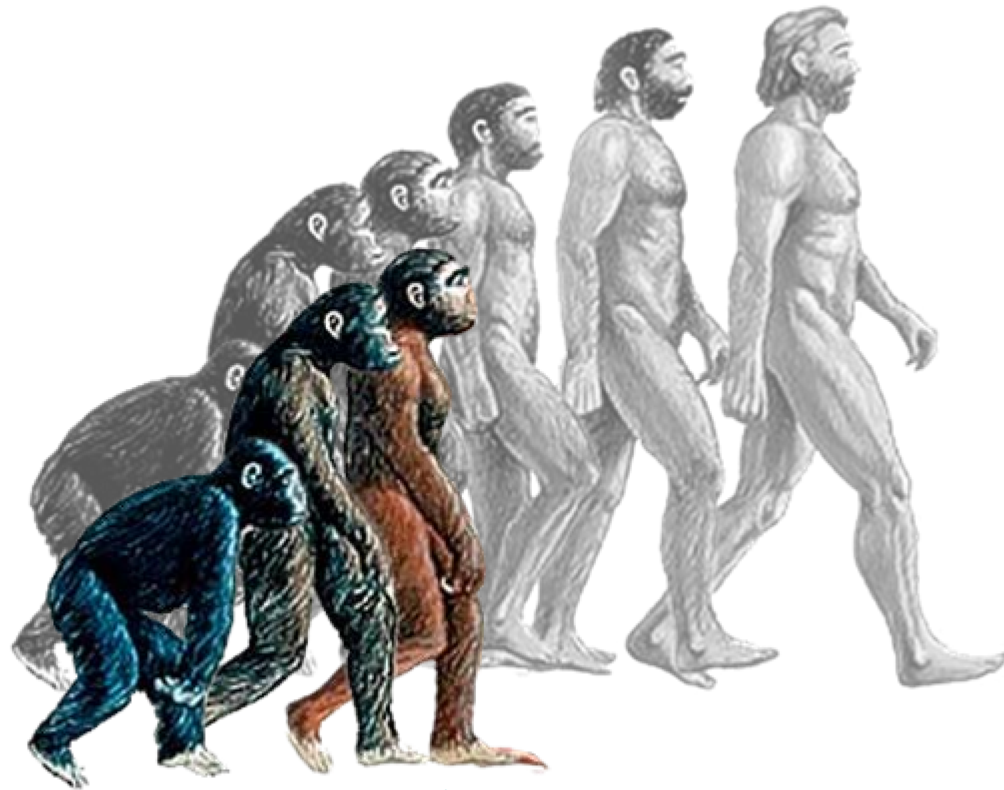
- Overview of Australian privacy law
- Likely changes post Australian Law Reform Commission's report on privacy



1984 – OECD Guidelines



1986 – Failed Privacy and Australia Card Bills



1988 – Privacy Act

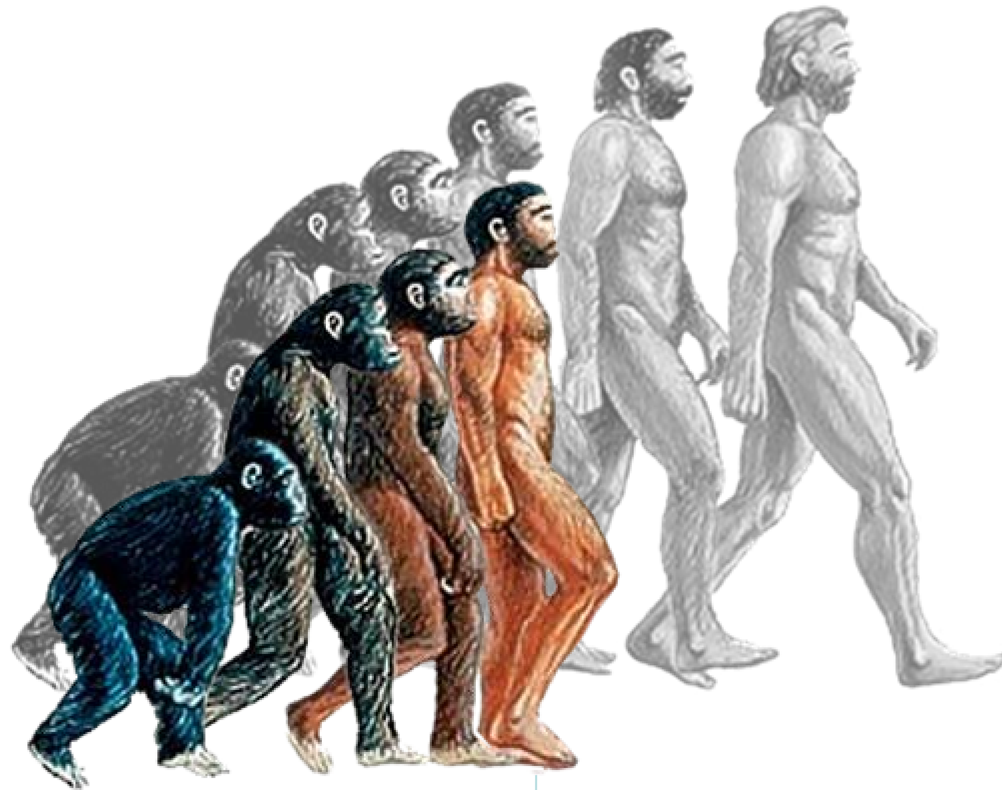
Overview of the Privacy Act

Protects personal information handled by:

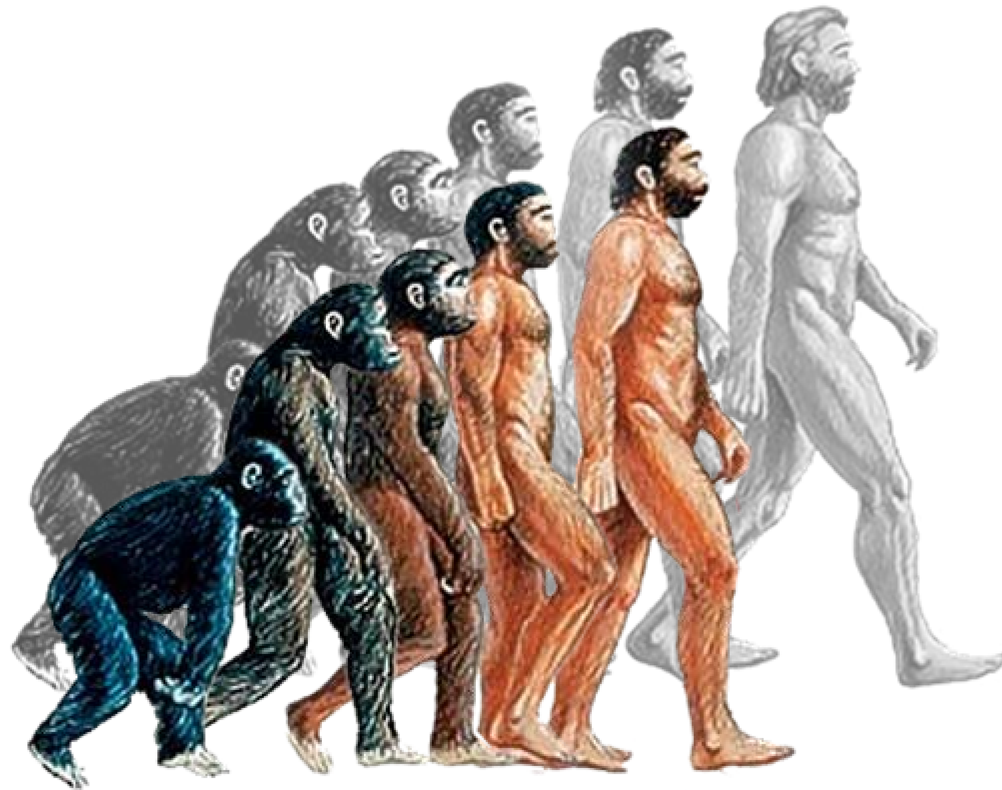
- Australian and ACT Government
- Businesses with an annual turnover >$ 3M
- All health service providers

Principles based:

- 11 Information Privacy Principles for government
- 10 National Privacy Principles for business



2000 - National Privacy Principles



2008 – ALRC completes privacy review

Privacy Law Reform

Government response in two stages:

First stage

- Unified Privacy Principles
- New technologies
- Health
- Credit regulation

Unified Privacy Principles

- Simplicity
- Consistency
- Reduce regulatory complexity
- Easier for people to understand privacy rights
- OPC recommended one set of principles in 2005

UPP 11 Cross-border data flows

- Changing information flows
  - Information being sent offshore
- Community attitudes
  - **90%** concerned about business sending information offshore
  - **63%** very concerned
- Ensures individuals have appropriate protections

MoU with New Zealand

- Share information about:
  - Surveys
  - Research projects
  - Promotional campaigns
  - Education and training
  - Investigations

APEC Privacy Framework

- Privacy Framework endorsed in 2004
- Data Privacy Pathfinder endorsed in 2007
  - 9 projects
  - OPC chairs 3 projects
  - Projects deal with cross-border enforcement and cooperation issues

ALRC and Credit Reform

- Improve consistency
- Reduce complexity
- 31 recommendations
  - 5 on Comprehensive Credit Reporting (CCR)

COAG 2008

- COAG agreed on measures on regulation and consumer protection
- Transfer of state legislation to Commonwealth
- Commonwealth to regulate new areas
  - Pay-day lending
  - Credit cards
  - Personal loans

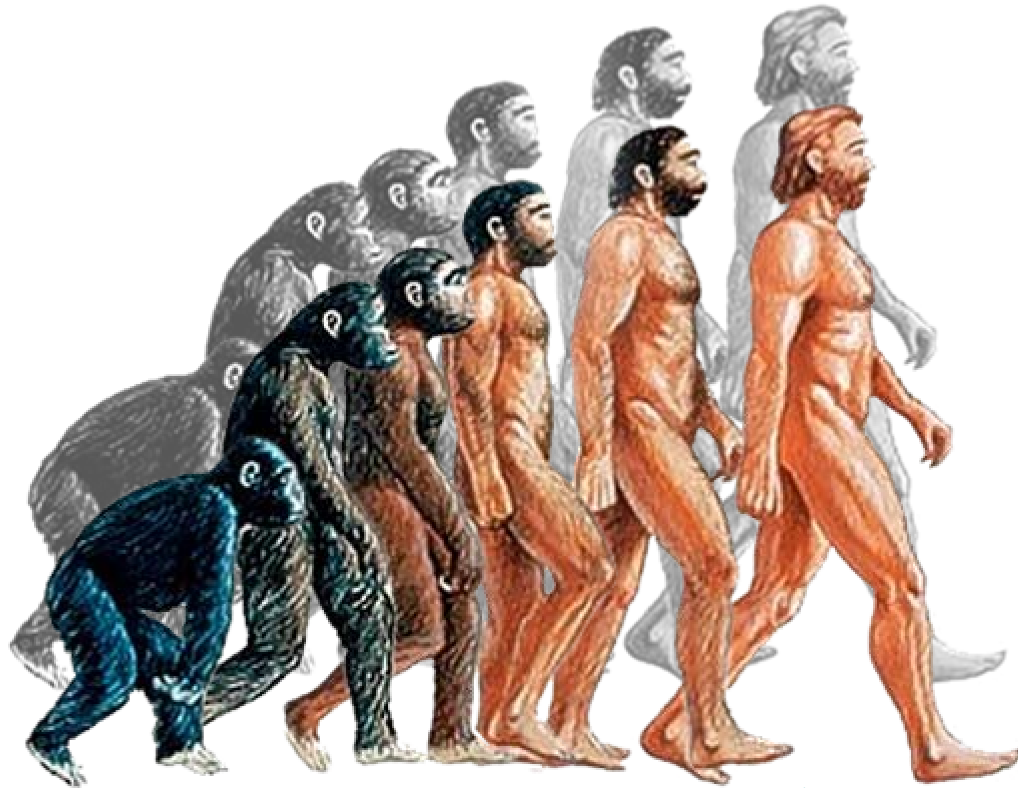
National Consumer Credit reform

- Two phases to ensure smooth transition
- Phase one
  - Establish national licence regime
  - Licensees observe general conduct requirements
  - Expanded scope for National Credit code
  - Mandatory membership of external ADR body

Comprehensive Credit Reporting

OPC View:

- Credit reporting provisions need reform
- Support simplified definition of credit reporting
- Must strike balance between efficiency in credit market and privacy protections



What next?

Australian Government
Office of the Privacy Commissioner

Privacy Law in Evolution: Across the Pacific

Crumble in the Jungle conference

Karen Curtis
Australian Privacy Commissioner

Gold Coast

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Privacy Law in Evolution: Across the Pacific

Marie Shroff
New Zealand Privacy Commissioner
Wellington

26th Annual Banking & Financial Services Law & Practice Conference (BFSLA)

crumble in the jungle

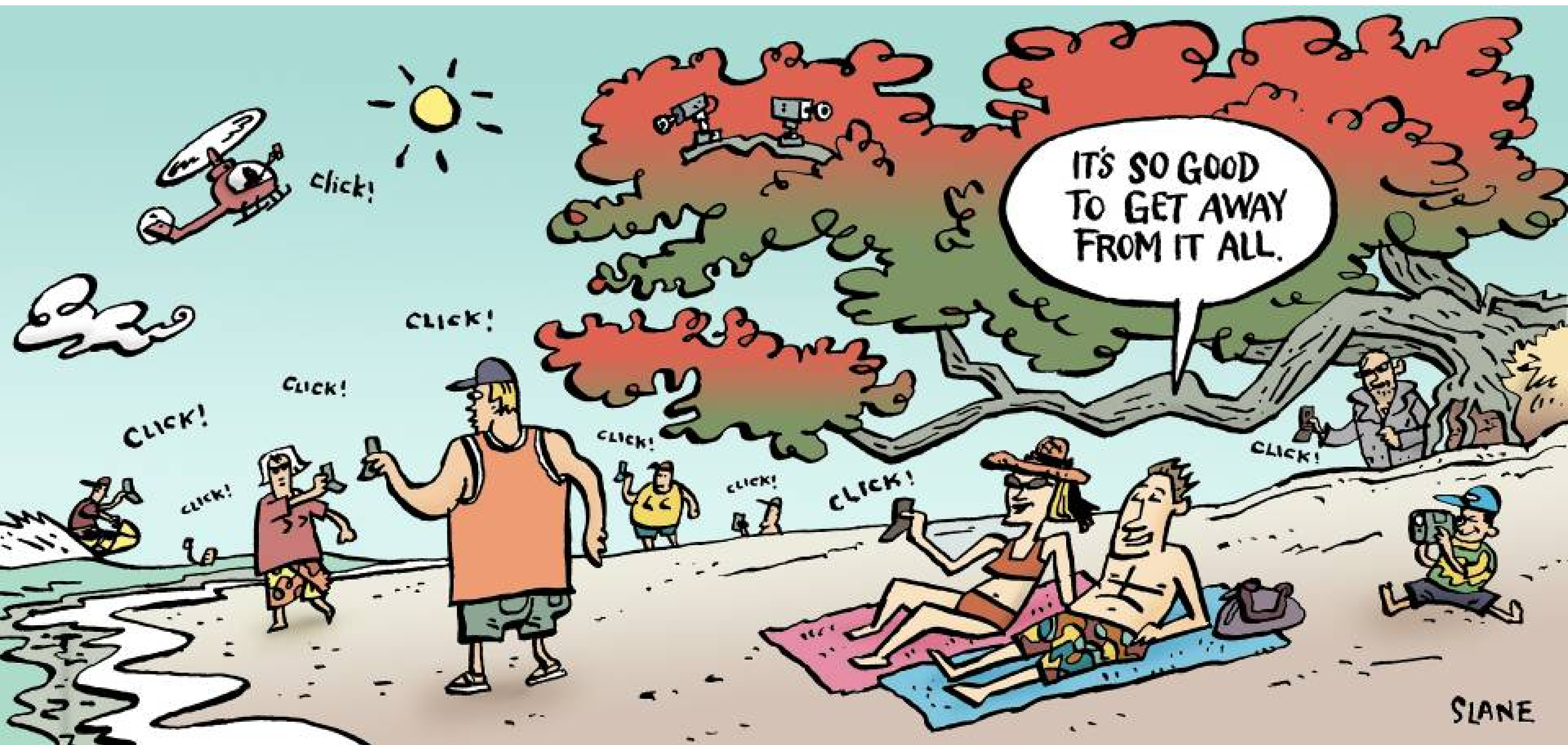
lessons from the Crunch

Friday 31 July 2009

Marie Shroff, Privacy Commissioner New Zealand

Privacy Commissioner
Te Mana Matapono Matatapu

DON'T WORRY MADAM, WE ARE ALL MOST INTERESTED IN PRIVACY AT THIS ORGANISATION.
CHRIS.



click!
CLICK!
CLICK!
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CLICK!
CLICK!
CLICK!
CLICK!
CLICK!
IT'S SO GOOD TO GET AWAY FROM IT ALL.
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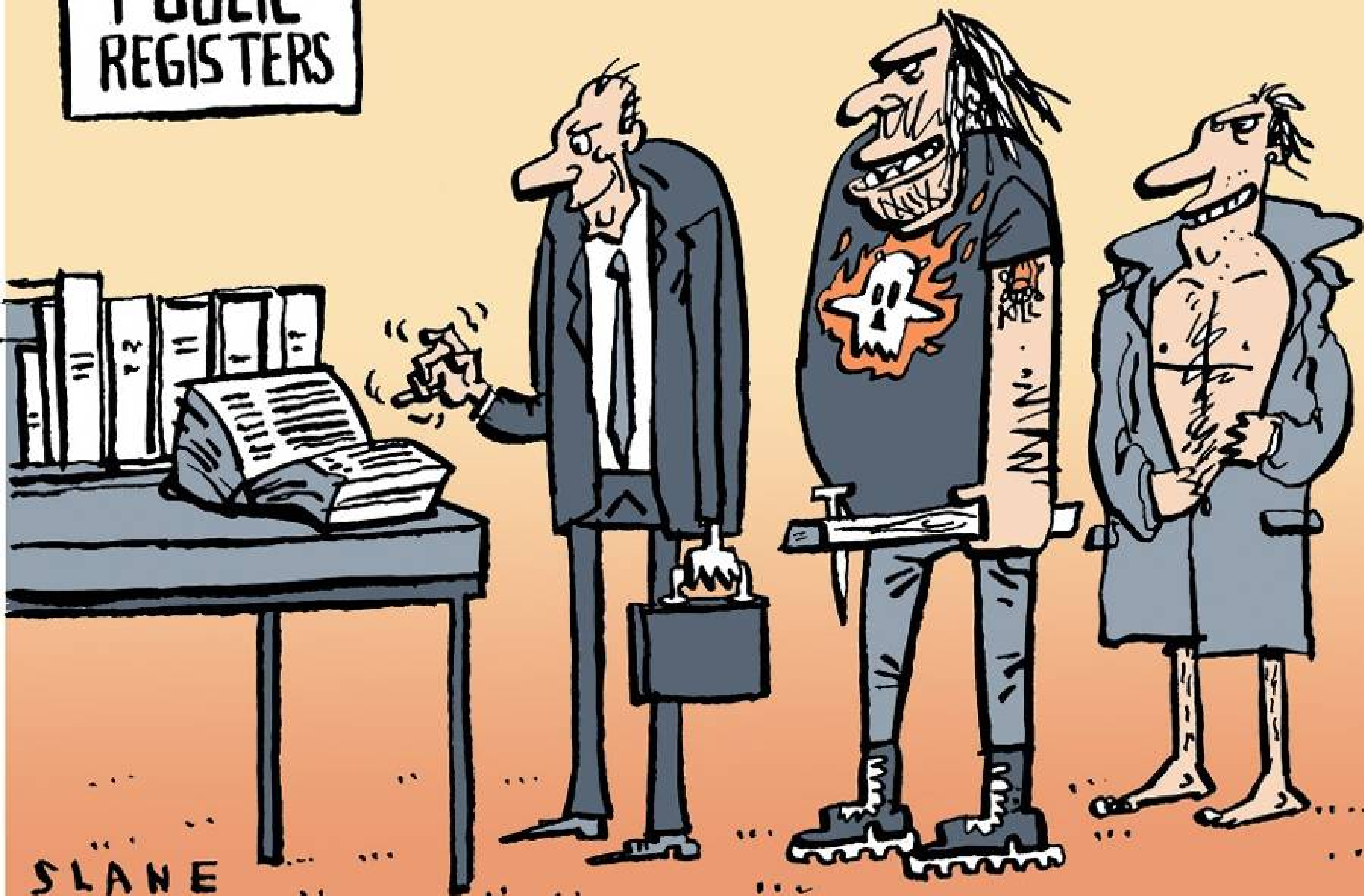
HI - I'M ONE OF YOUR FACEBOOK FRIENDS.
SLANE co.nz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CHRIS

SLANE
WE'RE HERE PURELY IN THE PUBLIC INTEREST, MADAM.

HACKERS FROM HELL
WE'RE IN!
BORN TO KILL
Welcome to HEAVEN
SLANE

THERE'S JUST SO MUCH MORE PERSONAL INFORMATION WITH DATABASES.
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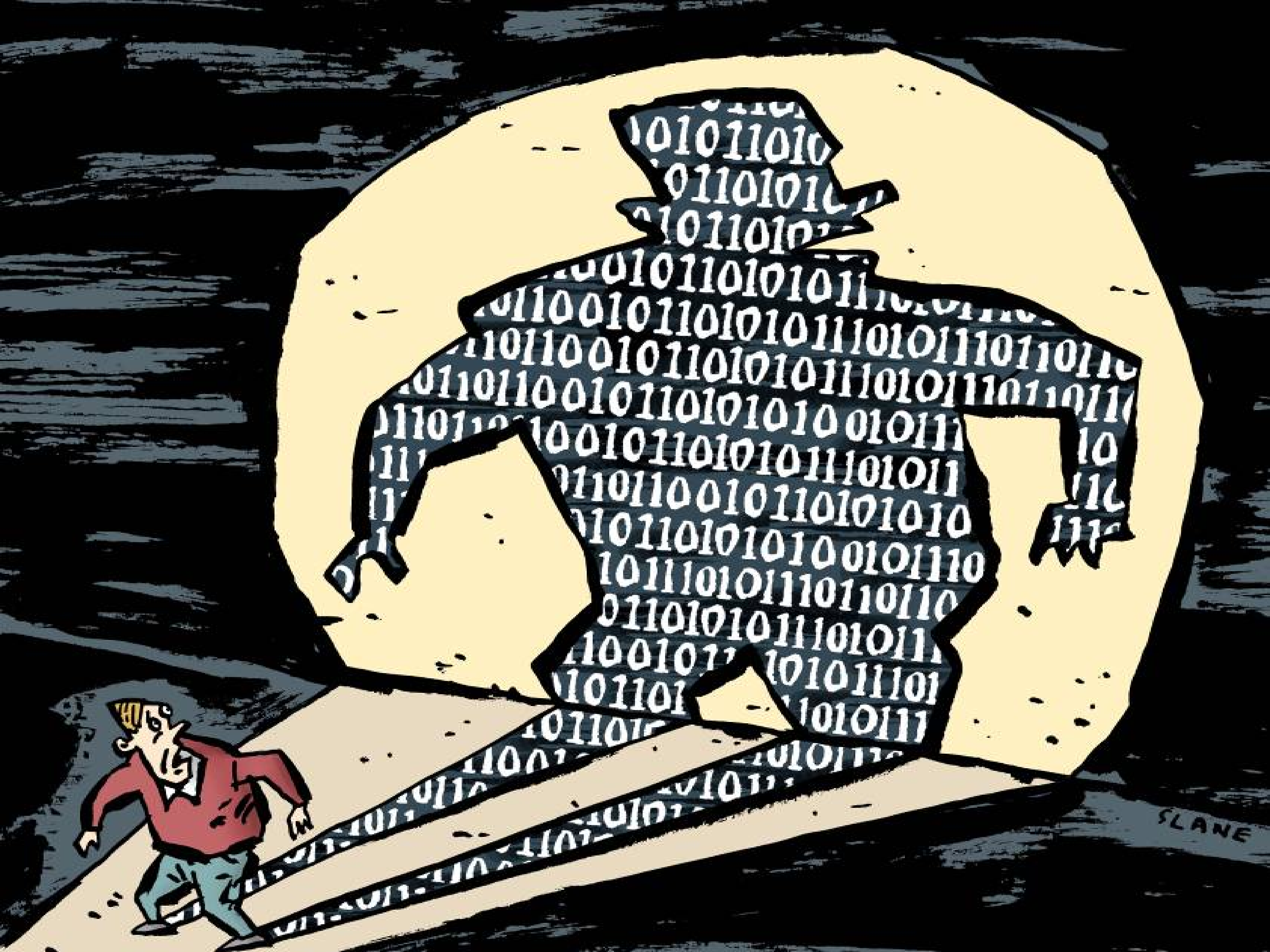
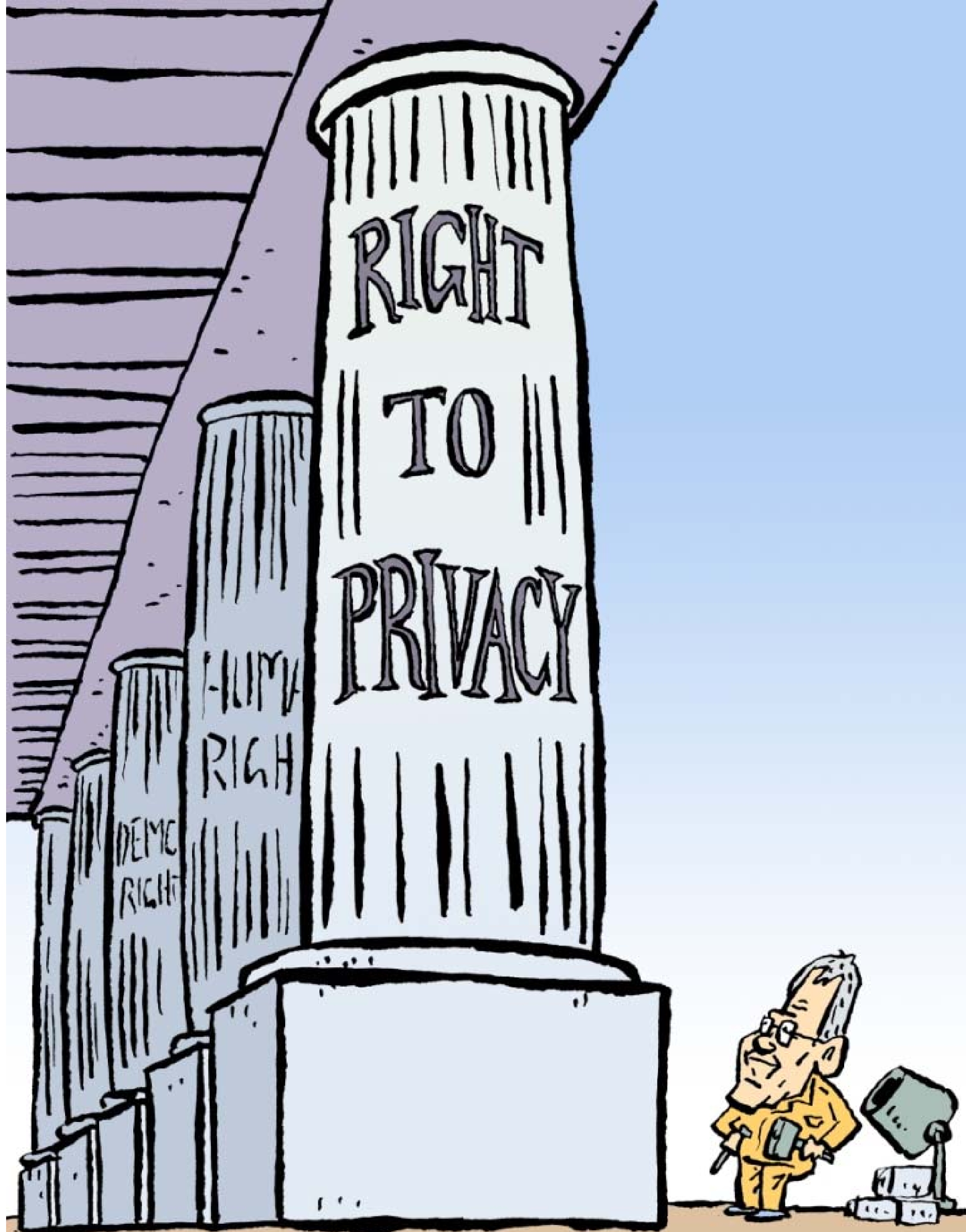

SLANE

GET ALL THE INFORMATION YOU CAN, WE'LL THINK OF A USE FOR IT LATER.
CHRIS

E-MAIL...
E-COMMERCE...
E-BANKING...
E-BOOKS...
E-GOVERNMENT...
E-EEEEK!
SLANE co.nz

INFORMATION
We don't give it out, only collect it.
SLANE

Oh, don't worry Mrs Davidson. It is only a small micro-chip implant behind the ear. No one with a clear conscience need have any concern.


RIGHT
TO
PRIVACY

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Privacy Law in Evolution: Across the Pacific

Katherine Forrest
Partner
Mallesons Stephen Jaques
Melbourne

MALLESONS STEPHEN JAQUES

31 July 2009

Katherine Forrest, Partner

Background

- Review of privacy related matters referred to the ALRC by then Attorney General Philip Ruddock in 2006
- ALRC Report released in August 2008
- Extensive suggestions for reform
- Govt has conducted some further consultation – detailed response and proposals not yet released

Overview

- Credit reporting
- Enforcement powers of the Privacy Commissioner
- Statutory tort of privacy
- Transborder data flows

Credit reporting and credit reform

- Current restrictions on content are prohibitive, query whether it provides sufficiently meaningful content
- Proposal to increase information contained in credit reports
- Introduction of new “responsible lending” obligation
- Comprehensive credit reporting should:
  - promote competition
  - enhance responsible lending decisions
- Credit reports for identity verification?
- Other uses?
- Abolition of section 18N – provision is unnecessary and confusing

Trends in Enforcement Powers
Australia

- Privacy Commissioner has traditionally taken a facilitative approach to regulation: assistance, advice and information
- Is a more muscular approach appropriate?
  - enough action taken?
  - enough powers to take sufficient action?
- Reforms proposed to strengthen investigative and enforcement powers – they should be proportionate
- Increase of powers will lead to increased use – be prepared, revisit privacy compliance

Statutory tort of privacy?

- Judicial interpretation of a common law right of privacy is developing – but direction is not yet clear
- Proposed statutory tort – “reasonable expectation of privacy”
- Current state of the law and regulation sufficient? Uncertain? Floodgates?
- If introduced, all common law rights should be superseded by statutory tort.

Transborder data flows

- Sensitive issue – particularly in context of outsourcing
- Balance between customer choice and business imperatives
- Currently requires adequacy of protection or consent
- Proposed introduction of 'accountability'
- Compare with "consent" only

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Privacy Law in Evolution: Across the Pacific
Some hot topics for Australia

31 July 2009

Katherine Forrest, Partner

The 26th Annual Banking and Financial Services
Law and Practice Conference

Sheraton Mirage Resort, Gold Coast

31 July -1 August 2009

Friday 31 July
3:30pm – 5:00pm

Hostage to the Vibe – the Future of Statutory Unconscionability in Banking Transactions

Chair:
Adam Thatcher
Partner, Allens Arthur Robinson, Brisbane

Speakers:
Prof. Bryan Horrigan
Professor & Associate Dean (Research) Monash University, Melbourne

Hon. Justice Andrew Greenwood
Federal Court of Australia, Brisbane

Hon. Justice Peter Blanchard
New Zealand Supreme Court, Wellington

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Hostage to the Vibe - The Future of Statutory Unconscionability In Banking Transactions

Prof. Bryan Horrigan
Professor & Associate Dean (Research)
Monash University
Melbourne

MONASH University
Law

Go Boldly.

‘Hostage to the Vibe’

‘The Future of Statutory Unconscionability in Banking and Finance Transactions’

Professor Bryan Horrigan
Louis Waller Chair of Law and Associate Dean (Research), Faculty of Law, Monash University
Consultant, Allens Arthur Robinson
Author, *Corporate Social Responsibility in the 21st Century* (2009, Edward Elgar, UK)

(Contact: bryan.horrigan@law.monash.edu.au)

Unconscionability Relates to …

- **Various equitable (and some common law) causes of action**
- **Statutory unconscionability under Trade Practices Act**
- **Statutory unconscionability under Fair Trading Acts**
- **Unconscionable financial services licensee conduct under Corporations Act**
- **Unjust contracts laws (eg some Fair Trading Acts, NSW Contracts Review Act)**
- **Related consumer credit laws**
- **Code of Banking Practice**
- **State retail/commercial leasing laws**

Common Unconscionability Arguments Made Against Financiers

- 'The financier's standard terms are unfair/unjust/unreasonable/ unconscionable … and are about to appear on the Federal Government's "unfair contract terms" blacklist!'
- 'The finance and security arrangements were executed in circumstances of misleading/unconscionable conduct by the financier'
- 'The financier extracted additional security from a financially stressed debtor unconscionably or in bad faith'
- 'The aggressive debt recovery tactics of the financier (and its agents) amounted to unconscionable conduct'
- 'The refusal of additional finance or the conditions attached to the granting of additional finance were each unconscionable'
- 'The way in which the financier exercised or threatened to exercise its security rights was unconscionable'
- 'The financier exercised its rights capriciously or in bad faith'
- 'The financier knew or should have known about its customer's unlawful conduct, and cannot benefit unconscientiously from that unlawful conduct to the detriment of another party with whom the financier also dealt'

Ongoing Statutory Unconscionability Reforms

- **Recent withdrawal of monetary limits for tertiary statutory unconscionability in TPA & ASICA**
- **Recent Productivity Commission and Senate Economics Committee reports**
- **Current Australian Consumer Law Bill before Parliament folds statutory unconscionability breaches under TPA & ASICA into new regimes for:**
  - pecuniary penalties, disqualification orders
  - redress loss/damage to non-party consumers
  - infringement notices, public warning notices
- **Separate Rudd Government review of B2B statutory unconscionability**
- **Ongoing judicial test cases on the elements/boundaries of non-statutory and statutory unconscionability**

Spigelman CJ in *A-G (NSW) v World Best Holdings* [2005] NSWCA 261

- ‘Over recent decades legislatures have authorised courts to rearrange the legal rights of persons on the basis of vague general standards which are clearly capable of misuse unless their application is carefully confined. Unconscionability is such a standard … Unconscionability is a concept which requires a high level of moral obloquy. If it were to be applied as if it were equivalent to what is “fair” or “just”, it could transform commercial relationships.’

de Jersey CJ (2005)

'The inherent vagueness of the concept of good faith when given contractual force stands to be contrasted with the general law's development of the principle of unconscionability. While obviously informed by considerations of fairness and reasonableness, that field is left in a state of reasonable definition and clarity, so that contracting parties can know where they stand. Others may not agree with that assessment (cf. B Horrigan: "The expansion of fairness-based business regulation – unconscionability, good faith and the law's informed conscience" (2004) 32 ABLR 159, 161). I note, though, that the High Court in *Tanwar Enterprises* (p 1857), deemed parties' positions in this area may be determined by reference to what it called "well developed principles"!'

Areas of Focus in Advice & Litigation

- ‘Well developed principles’

v

- Some of the elements of non-statutory unconscionability
- Many of its applications
- All of its correspondence with statutory unconscionability’s forms
- State and non-state regulatory implications of periodic statutory unconscionability reform amidst a torrent of related reforms

Current State of Play I

- **Meaning & Forms**: ‘unconscionability’ has more than one meaning at law, but its specific meanings in each of what I shall call ‘primary’, ‘secondary’, and ‘tertiary’ statutory unconscionability remain insufficiently determined under Australian law
- **‘Unconscionable Conduct’**: there is a range of equitable and other doctrines that draw upon specific ideas associated variously with conduct that is unconscionable and against ‘good conscience’, although legally the term ‘unconscionable conduct’ has a more discrete conventional meaning;
- **Judicial Discretion**: Commonwealth-level statutory unconscionability is one of a number of areas of statutory law whose interpretation and application successive legislatures have decided should be characterised by bounded discretion according to a matrix of unweighted indicative factors, and hence left largely in the hands of the judicial branch of government;
- **Gravitational Pull**: equitable notions of unconscionable conduct in general and the strand of unconscionable conduct associated with ‘special disadvantage’ in particular have to this point arguably exerted an overly strong gravitational pull upon the interpretation and application of all forms of statutory unconscionability

Current State of Play II

- **Political/Stakeholder Dissatisfaction**: the continuous series of legislative reforms and political reviews of statutory unconscionability in the areas of most relevance to the banking community reflects a degree of political and stakeholder dissatisfaction with the state of the law on statutory unconscionability and how Australian courts have generally approached it to this point, which financiers and their advisers ignore at their peril;

- **Reform 'Domino Effect'**: political reform and judicial interpretation of statutory unconscionability in the contexts of most interest to banking lawyers and other banking industry professionals affect cognate laws and national uniform schemes throughout Australia, and hence can neither be done in a vacuum nor sealed off from the corresponding non-banking statutory unconscionability regimes;

- **'Greenfield' Unconscionability Areas/Issues**: the multiplier effect of post-GFC litigation, ongoing governmental reviews of statutory unconscionability, and a wide range of unexplored 'test case' issues means that statutory unconscionability is likely to remain in a state and with a forward trajectory that are beyond the comfort levels of many banking lawyers and their clients

Pre-GFC & Post-GFC 'Greenfield' Statutory Unconscionability Litigation I

- **calling up bank guarantees**
- **making margin calls on share portfolios**
- **using class actions and litigation funders in unconscionability-related actions against financial advisers after the collapse of investment groups and markets**
- **targeting financially inexperienced investors with exploitative share purchase offers**
- **advantage-taking of financially distressed borrowers by 'fringe-dwelling' mortgage brokers who extract unreasonable fees for arranging unsustainable refinanced loans**
- **recalibrating pre-GFC and post-GFC prices for credit in conditions attached to financier consents and provision of financial assistance in ongoing relationships, at least where concessions are extracted that fall outside legitimate commercial interests**
- **knowing and taking advantage of security-giving companies without complete freedom to act in their own interests**

Unconscionability's Interface with Corporate Law and Major Corporate Deals

- ***Bell Group v Westpac*** **litigation not the last word on raising unconscionability in corporate contexts:**
  - result reinforces difficulty of dealing with unconscionability arguments at interlocutory stages
  - result influenced by available relief on other grounds
  - narrow reading of 'situational' disadvantage
  - conventional reading of disabling effect of disadvantage
  - heavy reliance on availability of legal advice (contrast French J in *Berbatis* litigation)
  - statutory unconscionability extends beyond special disadvantage

Pre-GFC & Post-GFC ‘Greenfield’ Statutory Unconscionability Litigation II

- making mid-transaction changes in conditions of finance that travel beyond what is reasonably necessary to protect legitimate banking interests
- guarding against misunderstanding or miscommunication in whether loan approval is conditional, provisional, or absolute, when it is later withdrawn on valuation, loan ratio, security assessment, material adverse change, or other ground
- meeting disclosure obligations in the reorganisation of debt, reclassification of liabilities, and reporting of materially adverse conditions (linked to disclosure under statutory unconscionability)
- extracting additional security from financially stressed corporations, engineering work-out situations for financially troubled corporate borrowers, and rearranging and refinancing corporate group debts, in circumstances (eg disproportionate security burdens, absence of corporate benefit etc) that invite exploration of the relationship between statutory unconscionability and corporate law
- safeguarding reverse mortgages, home equity loans, and asset lending arrangements involving vulnerable groups (eg aged family members)

FSR Legislation & Unconscionability (s991A(1) CA)

"A financial services licensee must not, in or in relation to the provision of a financial service, engage in conduct that is, in all the circumstances, unconscionable."

Unconscionability Under TPA s51AA & ASICA s12CA

- **“A corporation must not, in trade or commerce, engage in conduct that is unconscionable within the meaning of the unwritten law, from time to time, of the States and Territories.”**

- **“A corporation must not, in trade or commerce, engage in conduct in relation to financial services if the conduct is unconscionable within the meaning of the unwritten law, from time to time, of the States and Territories.”**

Meanings & Levels of Unconscionability Regulation

Under 'the Unwritten Law' (4 categories as described by Paul Finn):

- **Unconscionability as the underlying concept for Equity as a whole**
- **Unconscionability as an underlying policy rationale for or element of specific equitable/other actions (eg estoppel, relief against forfeiture, constructive trusts, economic duress, breach of fiduciary obligations, unilateral mistake, doctrine of penalties, unjust enrichment etc)**
  - Coercion/exploitation/advantage-taking
  - Unconscionable exercise of rights, retention of benefits etc
- **Doctrines & remedies associated with unconscionable dealings & inequality of bargaining power:**
  - 'spousal guarantees' rules (eg *Yerkey v Jones*, *Garcia*)
  - 'special disadvantage' rule (eg *Amadio*)
  - Others (eg *Bridgewater v Leahy*)
- **Unconscionability as a direct ground of relief in its own right, unmediated by conventional doctrines (eg *Lenah Game Meats v ABC*)**

Full Fed Ct in *ACCC v Samton Holdings* (2002)

- Unconscientious exploitation of a party's special disadvantage (eg *Amadio*)
- Defective understanding, relationship of influence, and absence of independent explanation (eg *Garcia*)
- Unconscionable departure from previous representation (eg estoppel – *Verwayen*, *Waltons Stores v Maher*)
- Relief against forfeiture and penalty (eg *Legione v Hateley* and *Stern v McArthur*)
- Rescind contracts for unilateral mistake (eg *Taylor v Johnson*)

ACCC v CG Berbatis Holdings Pty Ltd [2000] FCA 1376

- **The [tenants] suffered what might be called a ‘situational’ as distinct from a ‘constitutional’ disadvantage. That is to say it did not stem from any inherent infirmity or weakness or deficiency. It arose out of the intersection of the legal and commercial circumstances in which they found themselves. That disadvantage, not being constitutional in character, was not able to be mitigated by the fact of legal representation which they had available to them at all material times.**

‘Situational’ Disadvantage

- Not personal disadvantage, but flows from relationship circumstances (eg imbalance of financial/legal power or information): trial judge (French J) in *ACCC v Berbatis*
- Lukewarm reaction but not clearly ruled out: High Court in *Berbatis*
- Included by the Full Fed Ct in list of ‘unconscionable conduct’ categories in *ACCC v Samton Holdings*, but in a more confined way (eg ‘Or it may be situational, deriving from particular features of a relationship between actors in the transaction such as the emotional dependence of one on the other – *Louth v Diprose; Bridgewater v Leahy*’)
- Potential cross-over into s51AC/s12CC criteria, which are more relational/circumstantial
- Still being argued/pleaded in later cases: eg *Leslie v GE Commercial Corporation* (2007) and *Optus v Telstra* (2009)
- Independent legal advice does not neutralise ‘situational’ disadvantage: French J in *Berbatis*
- Possible counters to ‘situational’ disadvantage:
  - High Court in Berbatis emphasises being disabled from making judgments in own best interests (versus being unable to act in your own best interests because of financial/legal/bargaining imbalances)
  - Won’t necessarily help where the imbalance is informational, as that goes to judgment

Unconscionability Under TPA s51AC (cf s12CC ASIC Act)

- “A person/corporation must not, in trade or commerce, in connection with (a) the supply or possible supply of goods or services to a corporation/person or (b) the acquisition or possible acquisition of goods or services from a corporation/person, engage in conduct that is, in all the circumstances, unconscionable.” (s51AC TPA)

- “A person must not, in trade or commerce, in connection with (a) the supply or possible supply of financial services … to another person (other than a listed public company) or (b) the acquisition or possible acquisition of financial services … from another person (other than a listed public company), engage in conduct that is, in all the circumstances, unconscionable.” (s12CC ASIC Act)

Unconscionability under TPA s51AC & s12CC ASIC Act – A Different Result?

- Parties’ relative bargaining strengths
- Whether conditions extend beyond *what is reasonably necessary to protect legitimate interests*
- Understanding of the documents
- Any undue influence, pressure, or unfair tactics by a party or someone acting on their behalf
- Comparative prices and terms for availability of goods and services elsewhere
- Consistent with treatment of similar parties/transactions
- Compliance with any relevant industry codes
- Unreasonable failure to disclose (i) intended conduct which might affect the other party’s interests and (ii) risks to the other party arising from that conduct which reasonably they might not foresee
- Willingness to negotiate terms and conditions
- Whether parties act in *good faith*
- Whether contractual right exists to vary unilaterally a term or condition of a contract

ACCC v Westfield Clause

- ‘The Lessees irrevocably undertake that they will not at any time commence nor recommence or continue any action, claim, prosecution, litigation, arbitration, proceedings or administrative or governmental investigation or challenge whatsoever against or involving all or any of the Lessors and/or Westfield or any other person arising out of, in connection with:
  - the circumstances set out in the recitals above;
  - allegations arising out of or in any way connected with the Issues;
  - any contract, arrangement or understanding between the Lessees or anyone on their behalf relating to the Lessors and/or Westfield;
  - allegations arising out of or in any way connected with the Proceedings; or
  - the Lease.’

ACCC Media Statement on Westfield

- **"The ACCC considered that the condition might have impeded the tenants from approaching or assisting the ACCC in any investigation into Westfield's conduct."**

- **"Westfield acknowledged that the condition may have had the effect of discouraging the tenants from approaching or assisting the ACCC, although this effect was not intended."**

- **"The ACCC was concerned that this condition was not reasonably necessary for the protection of Westfield's legitimate interests in ensuring the finality of the private action between Westfield and the former tenants, and arose in circumstances where there was a significant difference in the relative bargaining strengths of the parties."**

Not a Clean Slate for Unconscionability Arguments …

- **In 2007, High Court reinforces its *ASC v Marlborough* rule that trial courts and intermediate appellate courts should follow earlier intermediate appellate court rulings on Commonwealth or uniform national legislation, unless they are 'clearly wrong': *Farah Constructions P/L v Say-Dee P/L***
- **High Court extends that to one national common law too: *Farah Constructions***
- **This affects both equitable *and* statutory unconscionability**
- **Clear intermediate appellate court authority saying that s51AA/s12CA unconscionability arguably extends beyond unconscionable dealings: eg *ACCC v Samton Holdings***
- **Clear intermediate appellate court authority saying that s51AC/s12CC extends beyond equitable grounds: eg Full Fed Ct in *Hurley v McDonald's Australia* (2000) and *ASIC v National Exchange* (2005)**
- **Already State Court of Appeal precedent in 2007 in unconscionability context for following Full Fed Ct approaches: *Canon Australia v Patton* (NSWCA)**
- **Practical/advice implications:**
  - Creates quasi-presumption in favour of earlier intermediate authority – ie can't just argue on a 'clean slate' basis
  - Precedent from outside your own judicial hierarchy (eg your own state of practice) is relevant
  - Makes strike-out/summary judgment applications harder, given the inherent nature of unconscionability-based arguments

Bank Guarantees & Unconscionability

- **Unjustified call on a performance guarantee or letter of credit can amount to unconscionable conduct (*Clough Engineering* and *Orrcon* cases):**
  - ‘Suggestions that performance guarantees or bonds should be treated as ‘good as cash’ should not, therefore, be treated as conveying some proposition of general legal application’
  - ‘There is authority that clearly supports the proposition that an inappropriate threat to call, or a call, on performance guarantees can be unconscionable conduct within s51AA of the Act’
  - ‘The principle of autonomy, applicable to a standby letter of credit, cannot override the Statute’ (echoing Austin J in *Boral Formwork*)

Implications for Financiers and Advisers

- **Unjustified calls on performance guarantees can implicate banks and their lawyers in:**
  - Assessing whether standard exception for fraudulent call-ups applies
  - Assessing whether unconscionability under any equitable forms applies (eg relief against forfeiture where one party's breach contributes to the other party's breach, unconscionable/unreasonable exercises of contractual rights, equitable relief where insistence upon strict rights is harsh/oppressive: see *Clough Engineering*)
  - Assessing whether s51AA TPA/s12CA ASICA, or s51AC/s12CC ASICA applies to the contracting parties
  - Assessing whether implied obligation of good faith or implied negative stipulation prevents call-up of performance guarantee
  - Ensuring that client banks are not exposed to risk of 'proposing to engage in conduct that constitutes or would constitute aiding or abetting … to contravene s51AA under Part IVA of the Act, or would, thereby, be directly or indirectly knowingly concerned in or party to the contravention' (see *Clough Engineering*)

Unresolved/Untested Issues - Advice/Litigation

- Constitutional validity of primary statutory unconscionability
- Whether judicial attitude to statutory unconscionability will change in light of politico-regulatory reform pressures
- Further judge-made extensions of *Amadio* and *Garcia* relationships
- How far ‘unconscionable conduct’ extends beyond *Amadio* and *Garcia* contexts
- Unclear spread of equitable, common law, and new notions of unconscionability across the various statutory unconscionability provisions (eg how much of unconscionable dealings, relief against forfeiture etc is imported)
- Status of *Berbatis*-like ‘situational’ special disadvantage for B2B & B2F contexts
- Difference between ‘acting in commercial interests’ (Berbatis) v ‘going beyond legitimate commercial interests’ (s51AC) v good faith synchronicity with legitimate commercial interests (s51AC and ‘implied good faith’ cases) v ‘good faith’ as unconscionability indicator
- Interaction between statutory unconscionability & corporate law
- How far courts technically adhere to the HCA’s instruction to follow what other intermediate courts have already ruled in this area

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Hostage to the Vibe -
The Future of Statutory Unconscionability
In Banking Transactions

Rt. Hon Peter Blanchard
A Judge of the Supreme Court of New Zealand
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"Hostage to the vibe"

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I became very nervous when I read in Professor Horrigan's excellent paper about the difficulty of assigning a meaning to unconscionability or unconscionable conduct in its Australian statutory guise or guises. As Professor Charles Rickett has observed, those terms have rapidly become prominent but largely incoherent features of the legal landscape. This is the warning that Rickett has given:[1]

> That there is no generally accepted meaning for unconscionability should immediately warn us off its use. It is not good enough to trumpet the rule of law, and then to apply the rule of men's hearts. The rule of law requires juridically applicable principles. To tell a cricket umpire to adjudicate on the basis of fairness would be to deny the game the right to be taken seriously; those who wanted to carry on playing the game would need to play elsewhere. To tell a judge to adjudicate on the basis of unconscionability would be to deny the law the right to be taken seriously; those who wanted to carry on living under the law would need to live elsewhere.

Perhaps that is why I choose to live in New Zealand!

The Judge-made law on unconscionable bargains over the Tasman is in much the same condition as it is here. It remains a "narrow principle", to adopt Spigelman CJ's description of it in equitable doctrine,[2] as quoted by Professor Horrigan in his paper.

The rationale is the relief of the weak in appropriate cases from bargains entered into as a result of their weakness. The crucial elements are:

1. The weaker party is under a significant disability.
2. The stronger party knows or ought to know of that disability.

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[1] "Unconscionability and Commercial Law" (2005) 24 UQLJ 73 at p 87.
[2] *Attorney-General (NSW) v World Best Holdings Ltd* [2005] NSWCA 261 at para [120].

3. The stronger party has victimised the weaker in the sense of taking advantage of the weaker's disability, either by active extortion of the bargain or passive acceptance of it in circumstances where it is contrary to conscience that the bargain should be accepted.

Those elements are crucial. Normally there will also have been a marked inadequacy of consideration and the stronger party either knew or ought to have known that to be so. As Deane J said in *Amadio*,[3] inadequacy of consideration is not mandatory but will almost always be present.

Often, too, there will have been some procedural impropriety but that is not a mandatory feature. Absence of independent advice to the weaker party is a frequent feature of unconscionable bargain cases. Where the weaker party did receive adequate independent advice it will be much harder for a successful allegation of unconscionable bargain to be made. I draw this summary of the way in which unconscionable bargain has been approached by New Zealand Courts from the judgment of Tipping J in *Bowkett v Action Finance Ltd*.[4]

You will appreciate that all this is very similar to the approach taken by the High Court of Australia in cases like *Amadio*,[5] *Blomley v Ryan*[6] and *Louth v Diprose*.[7]

On the subject of Judge-made law, I should add that we have not in New Zealand ever suffered from the limitations of *Yerkey v Jones*,[8] which we have never followed, or even of *Garcia*,[9] should there prove to be any such limitations. The leading undue influence case of *Wilkinson v ASB Bank Ltd*[10] applies quite broadly and expressly covers all family members and those in de facto relationships. I have no doubt that it would extend to gay relationships. Any differences between *Wilkinson* and the House

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[3] *Commercial Bank of Australia Ltd v Amadio* (1983) 151 CLR 447.
[4] [1992] 1 NZLR 449 (HC).
[5] (1983) 151 CLR 447.
[6] (1956) 99 CLR 362.
[7] (1992) 175 CLR 621.
[8] (1939) 63 CLR 649.
[9] *Garcia v National Australia Bank Ltd* (1998) 194 CLR 395.
[10] [1998] 1 NZLR 674 (CA).

of Lords' subsequent decision in *Etridge*[11] about recommended banking practice when obtaining a covenant from someone who may be acting under the influence of a principal borrower or may be otherwise disadvantaged are unlikely to be of much significance. The almost complete absence of cases arising in the decade since *Wilkinson* suggests that adherence by banks and other financiers to the recommendations in *Wilkinson* has largely eliminated the kind of problem that was often seen before that judgment was delivered.

But our subject today is *statutory* unconscionability and here Australian law is, depending upon how you look at it, much more developed or much more troubled. Today's paper may suggest the latter.

New Zealand did copy large parts of the Trade Practices Act in our Fair Trading Act 1986 and it has proved to be a useful and often salutary transplant. However, for reasons unknown to me, and critics might say no doubt more due to good luck than good judgment, we have never copied s 51AA or its derivatives. Nor have we endeavoured to create our own version.

And, so far, we do not have unfair contract terms legislation either, although the Ministry of Consumer Affairs has in a Discussion Paper[12] suggested that we might consider it.[13] That same Ministry, a little organisation with not much political clout, has suggested that if this is done it would not propose to recommend any amendment to the Fair Trading Act to make provision for prohibiting unconscionable conduct.[14] That was in May 2006 and I have not heard of any movement towards unfair terms legislation. It is certainly not beyond the bounds of possibility, however, that case law emerging from the current financial turmoil will produce a reaction from the Government and we may see legislation. To date no significant judgments have been delivered concerning the consequences of what Professor Horrigan calls the GFC, although I think we may have some quite soon.

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[11] *Royal Bank of Scotland plc v Etridge (No 2)* [2002] 2 AC 773 (HL).

[12] Ministry of Consumer Affairs, *Review of the Redress and Enforcement Provisions of Consumer Protection Law: International Comparison Discussion Paper* (May 2006).

[13] At pp 24 – 27.

[14] At pp 49 – 50.

What we do have already on the New Zealand statute book is something called the Credit Contracts and Consumer Finance Act 2003. As its name suggests, that Act is mostly about consumer contracts. It contains rules for them and also for consumer leases, credit-related insurance and buy-back transactions of land.[15] It prescribes remedies and enforcement procedures for those kinds of transactions only.[16] But then, in Part 5,[17] when it turns to provisions enabling the reopening of oppressive credit contracts, that Part is expressed to apply to "every credit contract (whether or not it is a consumer credit contract)".[18] A "credit contract" is defined[19] so as to include within its reach an arrangement that in substance or effect is a contract under which credit is or may be provided.

Section 120 is the central provision:

> **120 Reopening of credit contracts, consumer leases, and buy-back transactions**
>
> The Court may reopen a credit contract, a consumer lease, or a buy-back transaction if, in any proceedings (whether or not brought under this Act), it considers that—
>
> (a) the contract, lease, or transaction is oppressive; or
>
> (b) a party has exercised, or intends to exercise, a right or power conferred by the contract, lease, or transaction in an oppressive manner; or
>
> (c) a party has induced another party to enter into the contract, lease, or transaction by oppressive means.

I want to come back to the meaning of "oppressive" but before I do I should mention that there is a section which treats a refusal on the part of a financier to agree to early termination variation or waiver of a credit contract as the exercise of right or power under the contract.[20]

Section 124 directs the Court in considering a reopening to have regard to "all of the circumstances relating to the making of the contract … or the exercise of any right or

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[15] Sections 60 – 83.
[16] Sections 84 – 116.
[17] Sections 117 – 131.
[18] Section 117(a).
[19] Section 7.
[20] Section 121.

power … or the inducement to enter the contract"[21] and particularly whether the amount payable by the debtor, or the time given to the debtor to remedy a default,[22] or a refusal by the creditor to release part of the security, is oppressive.[23] The matter of relevance to today's subject is the definition of "oppressive", in s 118, as:

> oppressive, harsh, unjustly burdensome, unconscionable, or in breach of reasonable standards of commercial practice.

This definition, and the other provisions about reopening of credit contracts, have actually been brought forward from legislation first enacted in 1981.[24] This suggests that Parliament must have been content when it passed the new Act in 2003 with the relatively limited scope of judicial intervention under the 1981 Act. However, under the new Act an application can now be made by a regulator, the Commerce Commission, as well as by someone claiming to be a victim of oppressive conduct.

Because unconscionability is only one possible aspect of oppressive conduct under this Act, it seems fairly clear that in this statutory context it does not have to be restricted as it is in equity. For example, in equity it is necessary to show that the defendant was aware, or at least should have been aware, of the plaintiff's significant disability. But under the statute it may well be enough, to show oppression in the form of unconscionability, that there was such a disability and that the bargain was unfair. I do not mean to suggest, however, that a mere showing of unfairness is going to amount to oppression. It is plain from the case law that is not the position.

The first case on the 1981 provisions, *Italia Holdings*,[25] is the one most frequently cited, albeit it was at first instance. It involved the making of a loan to a property developer on condition that the borrower should purchase two properties from the finance company. The Court found this was not oppressive – nothing more than the ordinary give and take and bargaining inherent in commercial transactions generally. The borrow/developer had expertise and had access to independent legal advice. The Judge said that there had to be some real detriment or hardship involved before there

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[21] Section 124(a).
[22] Section 124(b)(i).
[23] Section 124(b)(iv).
[24] Credit Contracts Act 1981.
[25] *Italia Holdings (Properties) Ltd v Lonsdale Holdings (Auckland) Ltd* [1984] 2 NZLR 1 (HC)

could be said to have been oppression. The fact that the performance of the contract created difficulty for the plaintiff was insufficient. Injustice had to be shown to exist as well.

A case which went the other way was *Elia v Commercial & Mortgage Nominees Ltd*.[26] It involved a middle-aged Cook Islander with limited English and little or no business experience who was persuaded to render himself responsible for loans made so that his new de facto partner could acquire a business, which ultimately failed. He mortgaged his house to provide part of the security. He did get half the shares in the new business but it was never viable. The Court found that Elia had not understood the commitments he was making and had not received independent advice because the solicitor assigned to act for him was also the solicitor for the financiers. They had taken advantage of him. Gault J found that unconscionability was proved so that it would be inequitable to allow the securities to be enforced against Elia. And, if need be, he would also have found statutory oppressiveness justifying re-opening of the loan contracts. They were set aside.

In one of the few cases in which the Court of Appeal has considered what is oppressive, *Greenbank New Zealand Ltd v Haas*,[27] Tipping J said this for the Court:

> The various words which together form the definition of the term "oppressive" all contain different shades of meaning but they all contain the underlying idea that the transaction or some term of it is in contravention of reasonable standards of commercial practice. In a sense that phrase gives the underlying commercial rationale for the earlier words or phrases. Something which is, for example, unjustly burdensome must necessarily be regarded as being in contravention of reasonable standards of commercial practice; similarly with something harsh. To determine whether a contract or term is oppressive within any of the words or phrases in the definition, it is necessary to have some basis of comparison. In the context the comparator can only be what would be expected or acceptable in terms of reasonable standards of commercial practice. Something which is in accordance with such reasonable standards could hardly be held to be oppressive. Conversely something which is not in accordance with (i.e in contravention of) such standards is, by definition, oppressive.

[26] (1988) 2 NZBLC 103,296 (HC).
[27] [2000] 3 NZLR 341 (CA).

Greenbank v Haas concerned a very short-term unsecured loan to fund a 10% deposit on a land purchase by a company called Transworld for over $1 million which promised to be very lucrative for the purchaser. It would miss out on the opportunity if it could not fund the deposit. The loan contract provided for a rate of interest which was not abnormal, but there was also a finance fee of $45,000 and, when this was added in, the overall cost of finance for Transworld was 217.3% pa! Nonetheless, the Court found that oppression was not proved. It recognised that the venture had elements of profit-sharing, with the financier putting up a vital sum of money to pay the deposit and Transworld getting the advantage of the profit which it expected to derive from the resale of the land. There was no suggestion that the financier had taken advantage of difficulties Transworld was already in, save for its inability to finance a venture which it saw as profitable. There was no basis in the evidence for saying that the financier was not entitled to some premium by way of fee to reflect the nature of the transaction and the risks it was taking as an unsecured lender.

In a later case, *Raptorial Holdings Ltd v Elders Pastoral Holdings Ltd*,[28] the Court stressed that standards of commercial practice must be reasonable and, if they are not, they may be rejected as a valid basis for determining whether the transaction in issue is oppressive.[29]

Turning to statutory unconscionability in Australia, I confess I feel rather inhibited in commenting as the provisions are new to me and it is apparent that even those with years of experience with them are struggling somewhat to see where the courts are going or even where the legislators may have intended them to go.

I was intrigued to learn that your present Chief Justice has in an earlier life flirted with the notion that a special disadvantage could possibly arise just from circumstances, without the party who claimed to be suffering from a disadvantage being able to point to any personal characteristic like limited intellectual ability or education. If that approach came to be followed, it could mean that there would be great uncertainty

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[28] [2001] 1 NZLR 178 (CA).
[29] At para [56].

whenever a banker or other financier was asked to fund someone already in financial trouble. Could it later be claimed that particular securities or guarantees were only given at that time because of a special *situational* disadvantage making the taking of them unconscionable? Similarly, it would be very tricky advising a financier on calling up an advance or on enforcement of a security because of a situational disadvantage arising from insolvency of the borrower, regardless of whether there was some contributing infirmity or special weakness.

Merely to state this problem is perhaps to demonstrate how unworkable the concept of situational special disadvantage could be. I might have some difficulty in accepting, if I were a Judge in Australia, that legislators enacting the Australian statutory unconscionability provisions ever intended them to apply so broadly – so far beyond the metes and bounds of equitable unconscionability.

I suspect I would be in the camp of Gleeson CJ when in *ACCC v CG Berbatis Holdings Pty Ltd*,[30] as Professor Horrigan points out, the former Chief Justice warned against allowing situational disadvantage to take on a life of its own that might go too far beyond what existing equitable doctrines allow. Surely the concern to which the statutory provisions are broadly addressed is the protection of those who are vulnerable because of their personal weaknesses, not those who have chosen to fight a commercial battle and take commercial risks with their eyes open and ended up on the losing side. The consequences of losing may be hard, but such is the nature of capitalism. There will be winners and there will be losers. Any attempt by sympathetic Judges to mitigate the consequences for the losers, particularly at the expense of those whose role is merely to provide funding, might be productive of great mischief. Misplaced sympathy may have its own unintended consequences which I do not need to spell out to an audience of banking lawyers.

For these reasons, I would be supportive of what Professor Horrigan has called the "very clear conventional line" between, on the one hand, relief based on a disability which has the effect that someone cannot make a decision in their own interests and, on the other, a disability which affects only their power to act in their own interests

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[30] (2003) 214 CLR 51.

because of some commercial constraint. A disability arising from impecuniosity may straddle this line, however, and there perhaps interesting case law may emerge.

The 26th Annual Banking and Financial Services Law and Practice Conference

Sheraton Mirage Resort, Gold Coast

31 July -1 August 2009

Friday 31 July
3:30pm – 5:00pm

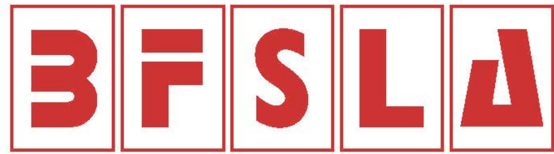
Securities Lending – Lessons Learnt

(Papers not available)

Chair:
Richard Fawcett
Partner, Blake Dawson, Sydney

Speakers:
Salvatore Algeri
Partner, Deloitte Touche Tohmatsu, Melbourne

Ross McClymont
Partner, Blake Dawson, Melbourne



The 26th Annual Banking and Financial Services Law and Practice Conference

Sheraton Mirage Resort, Gold Coast

31 July -1 August 2009

Saturday 1 August
8:45am – 10:00am

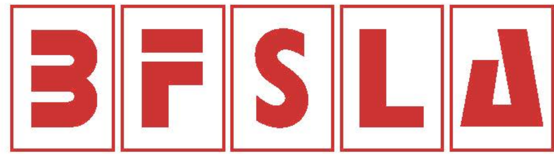
Director Duties and insolvent trading – the existing law and its effects

Chair:
Jonathan Oldham
Partner, Mallesons Stephen Jaques, Melbourne

Speakers:
John Sheahan SC
5 Wentworth Chambers, Sydney

James Douglas
Partner, Minter Ellison Rudd Watts, Wellington

Margaret Cole
Group General Counsel, Babcock & Brown Aust. P/L, Sydney



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31 July -1 August 2009

Director Duties and insolvent trading – the existing law and its effects

John Sheahan SC
5 Wentworth Chambers
Sydney

Australia's Insolvent Trading Regime – Concepts and Contrasts

John Sheahan SC

2009 Banking and Financial Services Law Association Conference

Sections 588G and 588H: Key Concepts

- … at the time when the company **incurs a debt**:
- the company is **insolvent** …, or becomes insolvent by incurring that debt, or by incurring at that time debts including that debt; and
- at that time, there are **reasonable grounds for suspecting that the company is insolvent**, or would so become insolvent …; and
- [the director] is aware at that time that there are such grounds for so suspecting; or
- **a reasonable person in a like position in a company in the company's circumstances would be so aware.**

Key Concepts - continued

- By failing to prevent the company from incurring the debt, the person contravenes s 588G.
- It is a defence if it is proved that, at the time when the debt was incurred, the person had **reasonable grounds to expect**, and did expect, that the company was solvent at that time and would remain solvent even if it incurred that debt and any other debts that it incurred at that time.

Civil Consequences

- Pecuniary penalty (s 1317G)
- An order disqualifying the director from managing corporations (s 206C)
- Compensation to the company for the loss or damage suffered by the creditor (ss 588J, 588M)
- Entire or partial relief may be available if the court is satisfied that the director acted honestly and in all the circumstances ought fairly be excused: ss 1317S, 1318

What are the insolvent trading laws about?

- An exception to corporate limited liability?
  - Indirectly exposes directors to creditors
  - But no exposure for shareholders who stand to gain if insolvent trading is successful
- A quasi-tortious duty not to mislead creditors?
  - Reflects a policy underpinning the law
  - But the liability is independent of disclosure or consent, and the remedy is not directed to the affected creditor

What are the insolvent trading laws about?

- A quasi-fiduciary duty to the creditors, to act in their interests?
  - Creditors' interests trump those of shareholders
  - But the duty is primarily enforceable by the liquidator and for the company
- A corporate governance rule?
  - A strong incentive for diligent and careful management
  - But operates like a compulsory personal guarantee for debts incurred between insolvency and administration

Five Questions

- Why a *duty* not to incur debts after insolvency?
- Do creditors need bespoke insolvent trading protection?
- Why penalise directors who trade whilst insolvent but improve the position of the company?
- Why not permit directors and creditors to contract out?
- Should all directors and shareholders be subject to the same rule?

Large/public vs SME/private

- Independence of directors
- Access to expert advice
- Responsiveness to advice
- Disclosure requirements and public scrutiny
- Attitude/involvement of bankers

A two-tier problem?

First Comparison – Insolvency Act 1986 (UK) s 214

(1) …the court, on the application of the liquidator, **may declare that that person is to be liable to make such contribution (if any) to the company's assets as the court thinks proper…**

(2) … if—

(a) the company has gone into insolvent liquidation,

(b) at some time before the commencement of the winding up of the company, **that person knew or ought to have concluded that there was *no reasonable prospect* that the company would avoid going into insolvent liquidation,** and

(c) that person was a director of the company at that time…

(3) [It is a defence if] **person took every step with a view to minimising the potential loss to the company's creditors as (assuming him to have known that there was no reasonable prospect that the company would avoid going into solvent liquidation) he ought to have taken**.

(4) … the facts which a director of a company ought to know or ascertain, the conclusions which he ought to reach and the steps which he ought to take are those which would be known or ascertained, or reached or taken, by **a reasonably diligent person** having both—

(a) the general knowledge, skill and experience that may reasonably be expected of a person carrying out the same functions as are carried out by that director in relation to the company, and

(b) the general knowledge, skill and experience that that director has.

UK vs Australia

- More latitude for directors to make decisions to maximise corporate wealth in circumstances of financial stress.
- Correspondingly, a weaker incentive to appoint external administrators – no compulsion to do so until inability to avoid doing so is clear.
- Less risk of premature appointment

Second comparison – Delaware

- No statutory bar on insolvent trading
- Some courts have entertained the idea of a cause of action for “deepening insolvency”
- Such a theory decisively rejected in Delaware:

Trenwick America Litigation Trust v Ernst & Young LLP per Strine V-C

"Even when a firm is insolvent, its directors may, in the appropriate exercise of their business judgment, take action that might, if it does not pan out, result in the firm being painted in a deeper hue of red. The fact that the residual claimants of the firm at that time are creditors does not mean that the directors cannot choose to continue the firm's operations in the hope that they can expand the inadequate pie such that the firm's creditors get a greater recovery. By doing so, the directors do not become a guarantor of success. Put simply, under Delaware law, "deepening insolvency" is no more of a cause of action when a firm is insolvent than a cause of action for "shallowing profitability" would be when a firm is solvent. Existing equitable causes of action for breach of fiduciary duty, and existing legal causes of action for fraud, fraudulent conveyance, and breach of contract are the appropriate means by which to challenge the actions of boards of insolvent corporations."

Delaware vs Australia

- An approach based in respect for contracts and entrepreneurship
- Treats directors as properly and adequately constrained by their ordinary duties and existing rules
- Leaves maximum scope for directors to make business decisions to increase corporate value even in insolvency

Some Reflections

- If the underlying problem is excessive risk taking by directors compromised by their ownership interests, should the solution reflect this? Could boards dominated by independent directors be carved out, or given the benefit of a business judgment rule?
- Should exposure exist in relation to all creditors? What of those who are fully informed but take the risk - for a price?
- What price is paid by the community in the form of premature/unnecessary administration?

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Director Duties and insolvent trading – the existing law and its effects

James Douglas
Partner
Minter Ellison Rudd Watts
Wellington

Observations on New Zealand's Reckless Trading Regime

James Douglas

BFSLA Conference: 1 August 2009

MinterEllisonRuddWatts
LAWYERS

New Zealand: Reckless Trading

- The Companies Act 1993 “codified” the established common law and equitable duties:
  - duty to act in good faith and best interests (section 131)
  - duty to use powers for proper purposes (section 133)
  - duty to exercise reasonable care, diligence and skill (section 137)

New Zealand: Reckless Trading

- The 1993 Act also created two bespoke statutory duties associated with insolvency:
  - duty not to carry on business in a manner creating a substantial risk of serious loss to creditors (section 135 – “reckless trading”)
  - duty not to incur obligations unless it is believed on reasonable grounds that they can be performed (section 136)

New Zealand: Reckless Trading

- Section 135 obliges directors not to allow:

  "*the business of the company to be carried on in a manner likely to create a substantial risk of serious loss to creditors*"

- When the test is parsed out, the conduct must give rise to:
  - a better than evens chance
  - of creating a substantial (not negligible) risk
  - of serious (material) loss
  - to creditors (insolvency)

New Zealand: Reckless Trading

- It is hard to resist the proposition that section 135 is an insolvency-specific subset of the duty of reasonable skill and care
- The test is objective
- The duty does not reflect a reckless knowledge standard
- The duty of skill and care also requires regard to be had to the interests of creditors in the zone of insolvency
- The need for a serious risk of substantial loss is not inconsistent with a negligence standard – the risk and extent of harm are both relevant in determining whether a duty of care arises

New Zealand: Reckless Trading

- Judicial concern has been expressed that section 135 may discourage enterprise by setting the bar for liability too low:

  - *Mason v Lewis* (CA, 2006):

    "The section has been strongly criticised as potentially unduly deterring directors from taking business risks …"

  - *Re Condrens* (HC, 2008):

    "*less clear is … the relationship between the specific duties of directors and the recognition that one purpose of the limited liability company is to allow for the taking of business risks.*"

New Zealand: Reckless Trading

- In this context, section 135 can be contrasted with section 320 of the 1955 Act, which required reckless knowledge:

  - *Re South Pacific Shipping* (HC, 2004):

    "*Reference as to what reasonable directors would have done or foreseen can easily lead to a process of thinking in which liability is imposed for negligence and not recklessness*"

    "*His behaviour departed so markedly from orthodox business practice and involved such extensive and unusual risks to creditors that it can fairly be stigmatised as reckless*."

New Zealand: Reckless Trading

- The same standard has been adopted for sections 135 and 136, despite the absence of a reckless knowledge requirement:

  - *Re Condrens* (HC, 2008):

    "*I do not consider that their conduct departed so markedly from orthodox business practice and involved such extensive and unusual risk that it can fairly be stigmatised as reckless.*"

    "*It would … be surprising … if a director's behaviour was to be assessed against a materially different standard depending on whether a particular obligation was incurred as part of a continuing series of transactions or … as part of a stand-alone transaction.*"

New Zealand: Reckless Trading

- When this judicially formulated test is compared with the text of sections 135 and 137, it is easy to see why there is uncertainty:

(1) The director's conduct departed so markedly from orthodox business practice and involved such extensive and unusual risk that it can fairly be stigmatised as reckless

(2) The director allowed the business to be carried on in a manner likely to create a substantial risk of serious loss to creditors

(3) The director failed to exercise the care, diligence and skill that a reasonable director would exercise in the same circumstances

New Zealand: Reckless Trading

- Further uncertainty results from the courts' power to relieve directors from liability on a relative culpability basis

- Claims in liquidation are usually prosecuted under section 301 of the Act - a streamlined application procedure entailing an essentially equitable judicial discretion to order contribution

- The courts have held that the degree of culpability is to be taken into account in assessing quantum under section 301, despite:
  - the legislature's abolition of the courts' wider discretion to relieve honest and reasonable directors from liability; and
  - the non-mandatory nature of the section 301 procedure

New Zealand: Reckless Trading

- The law lacks coherence:
  - We have bespoke statutory provisions that are being interpreted to require an extreme form of negligence
  - It is unclear how this standard reconciles with the common law standard of care and skill, preserved in section 137
  - We have a Judge-made basis for discretionary relief from liability, but only in respect of section 301 applications
  - Result: uncertainty for directors and insolvency officeholders

New Zealand: Reckless Trading

- The statutory test has created more rather than less uncertainty
- If the desire is to raise the liability bar in the interests of protecting enterprise, clear legislation to that effect is required
- Alternatively, get rid of bespoke statutory tests and leave it to judicial development of the common law negligence standard
- Under either scenario, the law needs to deal coherently with the courts' discretion to relieve from liability

The 26th Annual Banking and Financial Services Law and Practice Conference

Sheraton Mirage Resort, Gold Coast

31 July -1 August 2009

Saturday 1 August
10:15am – 11:35am

For whom the bell tolls - lenders, directors and workouts following Bell

Chair:
John Evans
Partner, Henry Davis York, Sydney

Speakers:
David Clarke
CEO, Investec Bank (Australia)

Margaret Cole
Group General Counsel, Babcock & Brown Aust. P/L, Sydney

Prof. John Stumbles
Faculty of Law, University of Technology, Sydney

Simon Lynch
Partner, Allens Arthur Robinson, Melbourne

Mark Korda
Partner, KordaMentha, Melbourne

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For whom the bell tolls – lenders, directors and workouts following Bell

John Evans
Partner
Henry Davis York
Sydney

FOR WHOM THE BELL TOLLS….LENDERS, DIRECTORS AND WORKOUTS FOLLOWING BELL

SPEAKERS

- Prof. John Stumbles –Faculty of Law, University of Technology, Sydney
- Margaret Cole – Group General Counsel, Babcock & Brown Aust. P/L, Sydney
- Simon Lynch – Partner, Allens Arthur Robinson, Melbourne
- Scott Kershaw – Partner, Korda Mentha, Sydney

THE TRIAL

- The hearing took 404 hearing days
- The plaintiffs opening itself took 120 days
- There were 166 witnesses
- The trial book consisted of 452,000 pages
- The transcript was 37,000 pages
- The judgment consisted of 2,643 pages, comprising in excess of 1 million words.

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31 July -1 August 2009

Saturday 1 August
11:35am – 12:50pm

PPS: Specific Issues - Chaos In The Making.....

Chair:
Michael Robinson
Partner, Simpson Grierson, Auckland

Speakers:
David Turner
Victorian Bar, Melbourne

Patrick Lowden
Partner, Freehills, Sydney

Steve Flynn
Special Counsel, Simpson Grierson, Wellington

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PPS: Specific Issues - Chaos In The Making.....

David Turner
Victorian Bar
Melbourne

PPSA in Australia – Chaos in the Making, or Brave New World?

PURCHASE MONEY SECURITY INTERESTS

> *A purchase money security interest (PMSI) is afforded a super priority under an Article 9 scheme. There are good commercial reasons for the super priority. First, the transaction is economically neutral. Secondly, to allow the holder of a prior registered security interest priority would result in the first being unjustly enriched at the expense of the second.*

The rationale for the purchase money security interest is bound up in the monopoly that the first in time priority lender enjoys because of the after-acquired property clause that is enshrined in PPS. A security interest attaches to new property without the requirement for any new act or transfer or appropriation by a debtor[1]. A security agreement that includes an after-acquired property clause[2] will result in any newly acquired property attaching to the security interest, it will automatically attach to new inventory (stock in trade) or accounts (book debts). Accounts usually represent the proceeds of the sale of stock in trade or inventory. Future advances are automatically tacked to the first priority by operation of s18(4).

Article 9 greatly improved the lot of the North American financier to take security over after-acquired property and their proceeds, which did not have the equivalent of the fixed and floating charge principally because of *Benedict v Ratner*[3]. Under the doctrine established in this case, unfettered dominion over the collateral and proceeds of a debtor was voidable as a fraudulent conveyance in bankruptcy. The floating lien is now firmly embedded in Article 9 and is not too dissimilar to the equitable charge over all present and future (after-acquired)

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1 S18(3).
2 S18(2).
3 268 US 353 (1925).

property that automatically attaches to the debtor's newly acquired assets without the need for any specific act of appropriation or execution of a new charge. This has been recognised under the common law and equitable rules since *Holroyd v Marshall*[4] and *Tailby v Official Receiver*[5]. There are obvious advantages in having the concept enshrined in legislation as this adds the certainty of the legislative basis and also hopefully sets the rules that apply to the PMSI.

The after-acquired property clause coupled with the first in time priority rule gives the first in time a monopoly over and, therefore, a competitive advantage over subsequent lenders. Gilmore[6] described this competitive advantage as the 'whole-hog after-acquired property clause'.

The first characteristic of a PMSI is that it was introduced to soften a 'situational monopoly' and enable a debtor to obtain finance on competitive terms[7].

Jackson and Kronman describe the after-acquired property clause as a 'situational monopoly'[8]. The authors also describe a PMSI as "an enabling loan—a loan that makes it possible for [a] debtor to acquire rights in property that he did not previously have"[9].

The second characteristic of a PMSI is its limitation to loans that can be traced to identifiable, discrete items of property. Barkley Clark[10] says the key to a PMSI is to find a direct nexus between the loan proceeds and the collateral.

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[4] (1862) 10 HL Cas 191. Generally, there is no difficulty in creating fixed and specific charges over a company's fixed assets such as plant and equipment, machinery, patents, business premises, land, etc, whenever acquired because of *Holyroyd v Marshall* , which decided that a lender acquires or has vested in it an equitable proprietary interest in the assets of a company immediately the company acquires the asset whether they be present or future assets.

[5] (1888) 13 App Cas 523.

[6] Gilmore, G: *Security Interests in Personal Property,* vol 2, page 779.

[7] T Jackson and A Kronman, *Secured Financing and Priorities Among Creditors* (1979) 88 Yale LJ 1143 at 1164-71.

[8] Ibid, p 1167.

[9] Ibid, p 1165.

[10] B Clark, The Law of Secured Transactions under the Uniform Commercial Code 2 ed 3.09[2][a].

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A PMSI only applies to after-acquired property if the purpose of the finance is to enable the debtor to acquire the asset and only to the extent that the funds are actually used by the debtor for that purpose for the logical reason that the debtor does not have title until after the funds are advanced or the credit given.

An article 9 regime does not give a debtor the right as against an earlier secured party to go out and obtain finance if the earlier security agreement prohibits further secured transactions absolutely or without prior consent. A breach of a negative pledge clause in the earlier security agreement will, as now, trigger an event of default entitling the earlier secured party to exercise its rights of enforcement, although the existence of a PMSI will not entitle the earlier secured party to proceed against the PMSI collateral because of the super priority afforded to the PMSI.

Anglo-Australian law has long recognised the purchase money security interest but it was not until *Abbey Building Society v Cann*[11] that the idea that there was a *scintilla temporis* was dispelled by the House of Lords and it was generally regarded that the purchase money security interest lender had priority over an earlier equitable mortgage[12].

The Bill[13] defines the purchase money security interest in section 14, unlike the New Zealand Personal Property Securities Act 1999 which deals with it in the definitional section[14]. The Bill clarifies certain matters but also includes a large amount of unnecessary and confusing verbiage.

Section 14 contains the following definition:

(1) A *purchase money security interest* means of the following:

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[11] [1991] AC 56. See also *Wilson v Kelland* [1910] 2 Ch 306, *Re Connelly Bros Ltd (No.2)* [1912] 2 Ch 25; *Sogelease Australia Ltd v Boston Australia Ltd* (1991) 26 NSWLR 1, *Security Trust Co v Royal Bank of Canada* [1976] AC 503, *Composite Buyers Ltd v State Bank of New South Wales* (1990) 3 ACSR 196 and *B & B Budget Forklifts Pty Ltd v CBFC Ltd* (2008) 13 BPR 25,419 on the effectiveness of a PMSI.

[12] See reservations about the effectiveness of PMSI without a statutory basis in RM Goode, Legal Problems or Credit and Security (3ed) 2003 at 190-193. Cf Ng G, Built on Quicksand: the purchase money security interest under the general law (2006) 80 ALJ 53-67.

[13] *Personal Property Securities Bill* 2009 (Commonwealth)

[14] S16.

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(a) a security interest taken in collateral[15], to the extent that it secures all or part of its purchase price;

(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;

(c) 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.

Exceptions

(2) However, a *purchase money security interest* does not include:

(a) an interest acquired under a transaction of sale and lease back to the seller; or

(b) an interest in collateral (as original collateral) that is chattel paper, an investment instrument, an investment entitlement, a monetary obligation or a negotiable instrument; or

(c) a security interest in collateral that (at the time the interest attaches to the collateral) the grantor intends to use predominantly for personal, domestic or household purposes.

Transactions included

The definition covers two main kinds of financing transactions. *First*, the interest of a *seller* in order to secure payment of all or part of the unpaid purchase price of property sold and, *secondly*, security interests taken by financiers for the purpose of permitting the debtor to acquire new assets. The definition also extends to deemed security interests, consisting of PPS leases and commercial consignments.

Section 14 makes it clear that the obligation secured by a PMSI is not limited to the purchase price or part of it but also extends to any credit charges or interest[16]. This is problematic because the secured party will also want to have his recovery costs included as well[17].

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[15] The words 'by a seller' have been wrongly omitted. Those words are necessary also because of deemed security interests, namely, a PPS lease and consignments.

[16] S14(1) refers to 'all or part' or 'to the extent that value is applied'; and s14(8) refers to credit charges and interest payable.

[17] Cf definition of advances in s 10 includes costs of recovery and enforcement of the security interest.

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Sale and lease back transactions excluded

Both s14(2)(a) and s16 (NZ) *exclude* a transaction of sale and lease back to the seller. The reason why a sale and lease back to the seller is excluded is because PPS does not apply to a transaction that is an outright sale and a genuine lease as there is no addition to the debtor's pool of assets[18]. No security interest arises despite the term of the lease.

Further, if the sale and lease back are not genuine but amount to a disguised secured loan involving the seller as borrower and the collateral is goods being sold there can be no sale to which a PMSI can attach.

Priority of PMSIs

Section 62 deals with priority of PMSIs. New Zealand's equivalent is section 73. The Bill allows 10 days to perfect by registration of a filing statement or the date of possession (NZ is the same) in the case of goods. Article 9 (§9-324(a)) is 20 days or the date debtor obtains *possession*. Generally under the Canadian legislation it is 15 days[19]. In the case of intangibles it is the date the purchase money security interest *attaches.*

The super priority of a PMSI also extends to proceeds. This is explicit in s62(2) in the case of inventory and s62(3) in the case of non-inventory collateral.

Procedure

PMSIs in goods that are not inventory.

Priority is gained if the security interest is registered (s62(3)(b)) and also the filing statement contains a statement[20] that the interest is a purchase money security interest (s62(2)(c)). A different rule applies depending upon whether the collateral is goods or other property ie intangibles. A secured party who

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[18] Cuming, Walsh and Wood , *Personal Property Security Law* (2005) p 332.

[19] Saskatchewan s34 – 15 days, Ontario is 10 days.

[20] The filing statement must comply with item 7 of the table in s153 by describing the class of collateral prescribed by the regulations.

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holds a PMSI in goods as collateral that is not inventory is afforded priority over every other security interest in the same collateral that is not a PMSI if the security interest in the PMSI is perfected by registration within 10 business days: s62(3)(b)(i). The 10-day period operates from the date of possession in the case of goods. If the collateral is property (intangibles) other than goods priority is gained if the security interest *attaches* to the collateral within the 10-business day period. The reason for the different treatment is because intangibles are not capable of being possessed. Inventory is treated differently because of the cut off rule that applies to buyers in the ordinary course of business.

A PMSI priority will be lost if there is an invalidating error in the filing statement such as an error in the serial number or the collateral is not described in the manner prescribed. Errors can be corrected so long as the financing change statement is lodged within the 10-day period. It is also possible to have the time for filing extended (s293).

The general priority rule requirements for serial numbered goods also apply equally to non-serial numbered goods (ss44 and 45). Motor vehicles held as inventory are not required to be described by serial number as this would impose an administrative nightmare. Also it is unnecessary to protect third parties as buyers and lessees take in the ordinary course of business except those who intend to hold the motor vehicles as inventory (eg s45(2)).

Note that unlike NZ and Canada goods or intangibles such as motor vehicles that are held as consumer goods do not enjoy purchase money security status (s14(2)(c)). The policy for this exception is not clear. Presumably it is because the policymakers believe that a consumer would not have given a prior general security in favour of a financier. Certainly there appears to be no reason given in the Explanatory Memorandum that accompanies the Bill. Canada requires some goods to be described by serial number if held as consumer goods.

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Policy behind registration by serial number is to ensure that a potential secured party can search with a high degree of confidence that a search would disclose a PMSI. This expectation is undermined if it is not possible to search in this way.

If inventory is perfected by possession rather than registration, the priority rules will not apply as the debtor never obtained possession. If the goods are later to be given to the debtor, registration by filing should be effected before possession in order to attract the super priority.

Requirement for possession as a debtor

What is the date for possession under s62(3)(b)? The section uses the words "before the end of 10 business days after . . . the day, the grantor, or another person at the request of the grantor, obtains possession of the property". A potential problem arises with this wording. What is the situation where debtor obtains possession of a printing press on a trial basis to determine whether it meets the debtor's needs? Some assistance is gained from the opening words in the section 'the purchase money security interest is perfected". These words imply that in order that time begins to run, the debtor must have granted a security interest in the goods. In other words the debtor must be obligated under a security agreement before time begins to run. Therefore time will only begin to run after the debtor has signed a security agreement agreeing to purchase the printing press. This because when the debtor first gained possession of the printing press he did so for evaluation purposes and not as a debtor[21].

The usual practice in Australia, at least in relation to cars, is that the debtor signs a security agreement (lease or hire purchase) that is subject to acceptance by the financier. The debtor takes possession of the car only after the financier has approved the finance and paid the dealer. If the agreement provides that the

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[21] *Guaranty Trust Co of Canada v Canadian Imperial Bank of Commerce* (1989) 2 PPSAC (2d) 88 (On HCJ). See the discussion on this point in J.S. Zeigel & D.L. Denomme in The Ontario Personal Property Security Act: commentary and analysis 2ed (2000) at 33.8 where the authors state that the Ontario Act was amended to include the words "as a debtor" to ensure that the position decided in *Guaranty Trust* was made explicity clear in the Act.

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owner may accept the debtor's offer by signing the agreement and/or paying the dealer, the date will be determined by reference to the date of signature by the financier. In a Canadian case[22], the court decided that the relevant date was the date of approval and not the date of signature of the security agreement.

Security Interests taken by sellers

S14(1)(a) deals with PMSIs taken by sellers. The words 'by a seller' have been deleted from the Bill. Security interests covered are those involving a sale on credit to secure the unpaid purchase price. The equivalent to the decision in *Wilson v Kelland*[23] which involved a sale of freehold property where the vendors agreed to let part of the purchase money remain on mortgage.

As mentioned above, a sale and leaseback is excluded. Sale and repurchase arrangements are also excluded for the same reason that the debtor's security pool is not enhanced[24].

In *Wheatland*[25] a combined harvester had been damaged in a fire and the owner (Baschuk) did not have the funds to repair it. The Baschuk sold the harvester to Ford Credit. Baschuk then sold the goods to Wheatland and later repurchased it from Wheatland. Bachuk obtained finance from Ford Credit. The security agreement was then assigned to Wheatland by Ford Credit. The Court looked at the substance of the transaction and said that there was no enhancement of the buyer's asset pool. From its inception, the underlying purpose of the transaction was to obtain funds in order to repair the harvester. The court said that the impugned transaction did not create a PMSI, but merely created the appearance of the same.

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22 *McLeod & Co v Price Waterhouse Ltd* (1992) 3 PPSAC (2d) 171 (Sask QB); 101 Sask R 115. See also the discussion of this issue at 73.5 of Gedye, Cuming and Wood, Personal Property Securities in New Zealand (2002).

23 [1910] 2 Ch 306.

24 *Wheatland Industries (1990) Ltd v Baschuk* (1994) 8 PPSAC (2d) 247 (Saskatchewan QB).

25 Supra.

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It is clear that a sale of goods on credit on an unsecured basis does not create a security interest. An agreement to grant a security interest after the sale cannot create a PMSI simply because on the sale the goods become the property of the buyer who at the time the security interest is granted is already the owner.

Enabling Loans[26]

In order for a lender to obtain a PMSI in collateral two conditions must be satisfied. *First*, the *purpose* of the loan of value must be for 'enabling the debtor to acquire rights in the collateral' and, *secondly*, the *value* must have been applied to enable debtor 'to acquire those rights' in the collateral.

It is unnecessary for the security agreement to contain a provision that the purpose of the loan is to acquire x or y so long as the purpose and application of the value to the acquisition of asset can be established by other means but it might be prudent to do so to avoid potential problems later on.

The language of the section implies that the loan proceeds must be actually used to pay for all or part of the new asset acquired, ie applied towards the enhanced pool of assets. It is best if the funds are paid directly to the seller of the goods or by direct credit to an account of the seller or by cheque payable to the seller.

Mixed value

Difficulties can arise where the funds are paid directly to the debtor and mixed with the debtor's own funds. If a dispute arises between secured parties, problems could arise because of the rule in *Re Hallett's Estate*[27]. This rule presumes that the debtor's funds are used first. If the debtor uses its own money to pay its creditors and also uses money from the PMSI lender's advance so that the amount of the advance is used in total or in part, then problems can arise.

[26] The term coined by Jackson and Kronman, *op cit.*

[27] (1880) 13 Ch D 696 (CA).

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This is illustrated by the following example taken from Cuming Walsh and Wood:[28]

> SP makes a loan to D to enable D to acquire a new rock crusher. A cheque for $20,000 is made payable to D who deposits it to D's bank account. At the time of the deposit, D has $30,000 credit balance in D's account. D withdraws $40,000 to pay a creditor. Later D deposits $10,000 from a third party source. D then withdraws $20,000 from D's account to pay for the rock crusher.

It is clear in this example that the purchase money advance has been reduced because under *Re Hallett's Estates* the debtor is presumed to have used his own money first and further withdrawals reduce the purchase money advance. The replacement $10,000 does not have the effect of replenishing the purchase money funds which have been reduced to $10,000. The result is that the purchase money security provider's PMSI priority is reduced to $10,000 because only $10,000 of the original advance was used to acquire the rock rusher[29]. This is conclusion is borne out by the words "*to the extent that* value *is applied to acquire those rights*" in s14(1)(b). S16(7) appears to be otiose.

Reimbursement

A typical transaction that is problematic and is not necessarily intended to be covered by the s14 is one involving a loan sought by debtor to buy a big ticket item where the debtor has already paid the deposit. The debtor not only wants the bank to finance the balance but the debtor also wants the bank to lend it additional moneys to reimburse it for the deposit already paid from company funds. Reimbursement of deposit moneys paid by the debtor to acquire goods cannot be an enabling loan because the debtor had already taken possession of the goods.

It is a difficult question from a policy viewpoint whether a purchase money priority should be given where a debtor gets a loan to pay off an open account.

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[28] *Op cit*, p 333.

[29] An example where the court have used the tracing principles is *Michigan National Bank v Flowers Mobile Homes Sales, Inc* 217 SE2d 108 (NC Ct App 1975).

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The US courts have decided that a loan by a bank to a purchaser of cattle being bought on an open account from a seller did not give the bank a purchase money security because the loan was merely to pay off a debt because the purchaser already owned the cattle at the time the loan was advanced[30].

Other courts have decided that it is sufficient if there is a close nexus between the purchase and the loan[31]. This basically means that the enabling loan process is two steps in a single transaction. It presupposes that the loans were planned from the beginning whereby debtor arranges a firm loan commitment with his bank to finance the goods in question, acquires the goods and then uses the lenders advance to pay the seller[32]. One view is that a loan arranged later after acquisition of goods is not regarded as an enabling loan[33].

It would seem that a loan arranged with a bridging financer enjoys purchase money security status. In order to attract purchase money security status it is necessary also to arrange a binding commitment with the later financier to pay out the bridging financier. The Saskatchewan Court of Appeal[34] decided that so long as there is a binding commitment by the later financier before the goods are acquired with the bridging financier's money, the bridging loan should be regarded as the first step in a two-step process that enables the debtor to acquire rights in the collateral. This is so despite the fact that the later financier's money was not used to pay the seller.

Professor Gilmore[35] is of the view that "*If the loan transaction appears to be closely allied to the purchase transaction, that should suffice. The evident intent . . . is to free the purchase money concept from artificial limitation; rigid adherence to particular formalities and sequences should not be required*".

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30 *North Platte State Bank v Production Credit Association of North Platte* 200 NW2d 1 (Neb 1972) discussed in B Clark *ibid* 3.09[2][a]. See also *ITT Commercial Finance Corp v Union Bank & Trust Co of North Vernon* 528 NE2d 1149 (Ind Ct App 1988)

31 *General Electric Capital Commercial Automotive Finance, Inc v Spartan Motors Ltd* 675 NYS 2d 626 (1998)

32 *Thet Mah and Associates Inc v First Bank of North Dakota (NA), Minot,* 336 NW 2d 134 (ND 1983)

33 *In Re Hansen* 85 BR 821 (B Ct ND Iowa 1988)

34 *Agricultural Credit Corp of Saskatchewan v Pettyjohn* (1991) 79 DLR (4th) 22

35 *Op cit*, Vol 2 782.

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Golden Rule is always pay the seller

Despite this Gilmore still counsels that no lender in his right mind will deliberately experiment with how much play there may be in the joints of the section; he will make his loan before acquisition and he will make it direct to the seller.

Deemed Security Interests

Subsections 14(1)(c) and (1)(d) make it clear that the interest of a lessor or a bailor and that of a consignor also enjoy purchase money status. So long as the procedural requirements are met, the lessor, bailor or consignor will enjoy the super priority of a PMSI.

Priority Rules

The general priority rule is set out in section 62(1). This provides that a PMSI will have priority over a general security interest in collateral or proceeds subject to compliance with subsection (2) in the case of inventory and subsection (3) in the case of a non-inventory PMSI. Section 63 deals with priorities between competing PMSIs. All PMSIs perfected under the rules in this section are subject to section 57 which deals with perfection by control.

Procedural requirements

There are two types of PMSI, collateral consisting of inventory and non-inventory. The procedural requirements for each are set out in s62.

Inventory

Notice requirement removed

Unlike Canada[36] there is no requirement for the secured party to give notice to other secured parties before advancing funds against inventory. The purpose behind the notice provisions in Canada is to warn existing secured parties that

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[36] Eg s34(3) Saskatchewan.

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the PM secured party is going to provide funds to enable the debtor to increase his stock so that they will not make further advances against swelled stock in the belief that the debtor has enhanced his asset base. Normally an existing secured party would search before making a further advance to ensure that no purchase money security interests have been registered. Impractical for general security holder to search before each advance

By dispensing with the notice requirements, inventory financiers are treated in the same way as non-inventory financiers. Given its purpose it is difficult to see the rationale for removing the notice procedure.

In order to secure priority as PMSI in inventory or proceeds, the SP must perfect his security interest before debtor obtains possession of goods[37]. In the case of other collateral (intangibles), attachment is sufficient.

Third requirement

The third requirement is that the filing statement must contain a notation that the security interest claimed is a PMSI. The collateral must also be described by class in accordance with the regulations: s153 item 7. This means that a reference to collateral as inventory or equipment or goods is insufficient[38]

Cross-collateralisation

In practice, a purchase money security interest will normally arise between a financier and a single debtor as is the case with a debtor obtaining finance for a fleet of cars, trucks or computers or acquiring some specific item of equipment as a one off.

[37] In a case where perfection is effected by possession by the SP, registration will not be required until possession is given to the debtor. The filing statement should be lodged before possession is given to the debtor.

[38] *Toronto Dominion Bank v Lanzarotta Wholesale Grocers Ltd* (1996) 12 PPSAC (2d) 30 (Ont CA).

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A separate security agreement will be taken for each or a master agreement entered into with each drawdown being treated as a separate security agreement in respect of the new asset being acquired but under the umbrella of the master agreement.

It is sometimes the case that the security agreement for the new assets will be cross-collateralised to some existing security such as an equitable mortgage or debenture charge or even a prior PMSI from the same debtor.

The question that arises will the act of cross-collateralisation result in loss of the purchase money security status? To put it another way, does the existence of an all moneys security over all present and future property of the debtor, which covers future advances negate a purchase money security, if for example a loan was made to debtor to acquire 4 prime movers?

The loan to the debtor to acquire the 4 prime movers will give the secured party a purchase money security in the 4 prime movers provided that they are registered by serial numbers.

If a further loan is made to the debtor will it be secured by the 4 prime movers? The answer is no because the new loan was not made to acquire the trucks.

Taken a step further assume that the debtor then requires a further loan to acquire trailers for use with the prime movers and security provider takes a new PMSI security agreement in similar terms to the first PMSI security agreement for them which also extends to secure any other goods sold to the debtor.

The US courts have taken the view that the extension of the security agreement to other goods results in a *transformation* of the PMSI to a general security agreement with the result that the purchase moneys security priority is lost by virtue of the operation of the cross-collateralisation clause. These clauses were known as add-on security clauses in the US.

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In *Re Manuel*[39] the court decided that automatic perfection of an add-on was inadequate where the collateral was insufficient to secure debt other than its own price.

In another case *Staley*[40] the court decided that the financier was saved by the presence of a first-in-first out provision in the security agreement. This provided for the PMSI in each item to terminate as soon as its purchase price was paid off.

Other courts have taken the *dual-status* approach resulting in the security being divided into purchase money and non-purchase money components. In the *John Deere* case[41], a debtor financed the balance of the purchase price of certain equipment under a security agreement that contained an after-acquired property clause and a future advances clause. The Court decided that a secured party can be a purchase money security financier even though the security agreement contained a cross-collateralisation clause, so long as the advance is actually used to acquire the goods over which a PMSI is claimed.

This position is now reflected in Article §9-103(f) which provides "In a transaction other than a consumer-goods transaction, a purchase money security interest does not lose its status as such, even if:

(1) the purchase-money collateral also secures an obligation that is not a purchase-money obligation;

(2) collateral that is not purchase-money collateral also secures the purchase-money obligation; or

(3) the purchase-money obligation has been renewed, refinanced, consolidated, or restructured."

The Bill seeks to deal with mixed securities in s14(3) and 14(4). This permits cross-collateralisation but reinforces the point that the PMSI is only security for

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[39] 507 F2d 990 (5th Cir 1975); 16 UCC Rep 493.

[40] 426 F Supp 437 (MD Ga 1977), 22 UCC Rep 799.

[41] 686 SW 2d 904; 309 UCC Rep 684 (Tenn) (1984).

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the PMSI obligation. It reinforces the PMSI status and provides that non-PMSI obligations are not secured by the PMSI. But does not achieve what 9-103(f) seeks to do.

Consequence is that the PMSI retains its status for the PMSI outstandings only.

Renewals are dealt with in s14(5). This provisions effectively tracks 9-103(f)(3).

The Bill fails to state that the purchase money security interest does not lose its status and simply picks up §9-103(f)(2) by providing that the purchase money security interest (arising under s14(7)) under the mixed security agreement is only one to the extent that it secures purchase money obligations: s14(3).

The PMSI actually arise under s14(1) not s14(7).

Section 14(4) covers the additional point that it is only purchase money collateral that secures the purchase money obligation and any other collateral does not. The effect of this is that a financier cannot get extra security for the purchase money obligation that also enjoys the super priority status. The use of the words "to the extent" recognise that possibility that a security agreement can secure both purchase money and non-purchase money obligations[42].

Section 14(5) deals with renewals, etc and effectively picks up the full benefit of Article §9-103(f)(3) because it uses the same wording that "it does not lose its status" but it also adds on the words "(whether or not by the same secured party)". The words in parentheses should remove any doubts that might exist about the status of a PMSI that is refinanced through another lender or lenders in a consolidation.

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[42] *In Re Billings* 838 F 2d 405 (10th Cir 1988). This case involved a new note and new security agreement. The court decided that the refinancing and renewal of the PMSI did not transform the PMSI into a non-PMSI.

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Refinancing and consolidation

Section 14(6) deals with the application of moneys under a PMSI. This provision pick up the priority rule problems that the US and Canadian Courts have grappled with over the years with refinancing, debt consolidation and transfers. They provide the rules that apply where the security agreements fails to provide a contractual formula dealing with the how payments are to be apportioned between purchase money and non-purchase money components.

In the US some Courts traditionally used the *first in first out* rule[43]. In Canada in a case involving a consolidation of a purchase money security with a non-purchase money security the Court decided that the secured party had to prove the existence of the PMSI first and then prove that the debt was due in *Gerrard*[44].

The US Courts have also used the *pro rata* rule. This may be more appropriate in a consolidation of two separate obligations in a financing but the first in first out rule may be more appropriate in the case of a sale as in *Gerrard*.

In another case, *Battlefords*[45] the Court of Appeal took the easy way and decided that the purchase money secured party had a PMSI in all of the property that had been subject to the PMSI. It failed to look at how much was owed under each separate PMSI. The difficulty with the later approach is that the result would probably put the PMSI holder at an advantage vis-à-vis the general security holder because this approach effectively allows the PMSI holder to tack priority money on to the most valuable item of property in circumstances where there could be shortfall because the other PMSI debt had been reduced to a much smaller amount. This can be illustrated by the consolidation of two PMSIs.

Assume that $5,000 is owing under PMSI (1) securing a truck worth $25,000 and $12,000 is owed under PMSI (2) another truck worth $9,000. Debtor defaults

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[43] Eg *In Re Conn* 33 UCC Rep 701 (WD Ky 1982).

[44] *Re Gerrard* (2000) 20 CBR (4th) 90 (NSSC).

[45] *Battlefords Credit Union Ltd v Ilnicki* (1991) 82 DFLR (4th) 69 (Sask CA). See Duggan A, Hard Cases, Equity and the PPSA in 34 Can Bus L.J. 129 (2001).

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and the goods are taken by the PMSI holder. The consolidated debt is $17,000. The PMSI secured party then says to general secured party that I am entitled to recover the $17,000 by resorting to both PMSIs. The effect of *Chrysler Credit Canada Ltd v Royal Bank of Canada*[46] decision is that the moneys can be tacked onto the other PSMI collateral.

Cuming, Walsh and Wood[47] say that this is wrong because the wording of the section refers "to the extent of". This means that the general security holder who registered first takes the excess from PMSI(1) because the balance of the sale proceeds after exhausting the PMSI are $20,000 less $5,000, which is not accorded PMSI status. The balance therefore goes to the general security holder.

The effect of the *Chrysler* decision has been reversed in s34(9) of the *Saskatchewan Personal Property Security Act* 1993. That section provides that a PMSI *in an item of collateral does not extend to or continue in the proceeds of an item after the obligation to pay the purchase price of the item or to repay the value for the purposes of enabling the debtor to acquire rights in it has been discharged*.

The result of this is that the prior general security holder picks up the equity in the collateral after repayment of the PMSI obligation because he is first in time.

There is no equivalent of this provision in the Bill.

Logically, this is a result but there is no certainty without an amendment to the Bill.

Section (6) provides a reallocation method based on Article 9-103(e) of Article 2001 Revision that attempts to resolve tension between the *first in first out* and the *pro rata* rules.

[46] [1986] 6 WWR 338 (Sask CA).
[47] *Op cit* at p 345.

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CONCEPT OF 'VALUE'

A secured party must have given value before a security interest attaches to collateral. The value must be real value. A cheque given as the value which is later dishonoured does not qualify[48].

Value is defined in s10 as 'consideration that is sufficient to support a contract' and 'includes an antecedent debt or liability'. This would include a promise to pay the purchase price, a forebearance to sue and a binding commitment[49] to give credit.

Section 10 also says that in relation to a PMSI has a meaning affected by section 14. Section 14(8) provides that value includes a reference to credit charges and interest payable for the purchase or loan credit. Section 14(8) does not seem to add anything to the definition of value *simpliciter* as it appears to go to the question of priority moneys.

At general law these items are part of the costs of getting your money back.

The Canadian cases say that value is given as soon as the secured party makes a binding commitment to extend credit to the debtor[50]. Cuming, Walsh and Wood suggest that the position is the same with a line of credit even if the debit balance was nil at any given time so long as the commitment has not been cancelled.

A security agreement under seal or executed as a deed qualifies as consideration under general contract law[51] although the definition of value only refers to consideration. This essentially because of the antecedent debt point which is overcome by deed at common law.

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[48] *Dale Tingely Chrysler Plymouth Ltd v Chris & Don Enterprises Ltd* (1994) 8 PPSAC (2d) 191.

[49] This is important because of the reimbursement point mentioned above in relation to the PMSI.

[50] See for example *Agricultural Credit Corp of Saskatchewan v Pettyjohn* (1991) 1 PPSAC (2d) 273 at 282 (CA).

[51] *Heidelberg Canada Graphic Equipment Ltd v Arthur Anderson Inc* (1993) 7 BLR (2d) 236.

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Value includes an antecedent debt or liability thus enabling unsecured debt to be converted to secured debt.

It is thought that the inclusion of past consideration does away with the need to include words such as 'forbearance to sue' in the security agreement.

GOOD FAITH AND THE COMMERCIALLY REASONABLENESS

The Personal Property Securities legislation of New Zealand and Canada, including Article 9, impose an overriding obligation on a secured party to act in good faith and in a commercially reasonable manner in the exercise of its rights, duties, and obligations under a security agreement[52].

The New Zealand Act (s25) provides:

> (1) All rights, duties, or obligations that arise under a *security agreement or this Act* must be exercised or discharged in *good faith* and in accordance with *reasonable standards of commercial practice*.
>
> (2) A person does not act in bad faith merely because the person acts with knowledge of the interest of some other person.

The Saskatchewan Act (s65(3) and (4)) provides:

> (1) All rights, duties or obligations that arise pursuant to a *security agreement, this Act or any other applicable law* are to be exercised or discharged in good faith and in a *commercially reasonable manner*.
>
> (2) A person does not act in bad faith merely because the person acts with knowledge of the interest of some other person.

The approach in the Bill differs significantly and essentially picks up the Article 9 duty. The Bill (s111) provides:

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[52] Eg S65(3) Saskatchewan, s 25 NZ

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(3) *All rights, duties and obligations that arise under this Chapter*[53] must be exercised or discharged:

(a) *honestly*; and

(b) in a *commercially reasonable manner*.

(4) A person does not act dishonestly merely because the person acts with actual knowledge of the interest of some other person.

The principal significance of the duty to act in a commercially reasonable manner is to be found in the enforcement provisions of the North American legislation and in the New Zealand legislation. The Bill confines this duty only to the enforcement provisions in Chapter 4.

Subsection (4) deals with the priority issue but this is not necessary because the duty is limited to enforcement and does not include under the security agreement or under the Act as well or as in Saskatchewan under any applicable law.

The standard set by the duty has two aspects, namely, honesty and commercial reasonableness. Neither concept is defined and no guidance is given as to what good faith or honestly mean in this context. Neither good faith nor honesty is defined in the Canadian legislation.

Article 9 itself does not defined good faith but the definition is to be found in UCC §1-201(20). It is defined to mean "honesty in fact and the observance of reasonable commercial standards of fair dealing".

Where does this leave us for guidance?

It is thought that the answer lies in the *Bills of Exchange Act 1909. "*A thing is deemed to be done in good faith, within the meaning of this Act, where it is in fact done honestly whether it is done negligently or not": s96. So far so good. What then does honestly mean? It would seem that mere negligence, however gross, not amounting to wilful fraud or fraudulent blindness and abstinence from inquiry, will not of itself amount to lack of honestly or bad faith[54]. In *Jones v*

[53] Chapter 4. This chapter deals with the enforcement of security interests.

[54] Goodman v Harvey (1836) 4 A & E 870

Gordon[55], Lord Blackburn was of the view that honest blundering and carelessness were not dishonesty but a dishonest refraining from inquiry was dishonesty.

The words 'whether it is done negligently or not' are absence from the section[56]. The fact that one has actual knowledge seems to operate in much the same way as the fraud element in relation to the Torrens system, notice is not fraud nor is notice bad faith or a failure to act honestly.

Gilmore[57] says that the "secured party's overriding obligation is to act (as the Code puts it) in a 'commercially reasonable' manner, or (as judge Desmond put in *Kaimie*[58]), 'in good faith', or (as Judge Learned Hand, citing *Kiamie*, once put it) with a 'reasonable regard for the pledgor's right' ".

The test therefore seems to be whether the person acted with honest intent. This is a subjective test demanding honesty in fact which is borne out by Lord Blackburn's view and the use of the word 'honestly'. This view is supported also by the words that 'a person does not act in bad faith because the person acts with knowledge of the interest of another person' in s111(2).

The mode of conduct set by the use of the words 'in a commercial reasonable manner' seems to focus on the market practices of a secured party. This translates to the observance of commercial standards of fair dealing.

The difficulty with the duty in s111 is the ability of a secured party to contract out of the certain enforcement provisions (s115) other than s111. Also Chapter 4 does not apply to property while under the control of a receiver or receiver and manager or a controller (s116). This is an odd provision and probably renders the duty nugatory given the receiver will undoubtedly be exercising the rights and remedies that the secured party has and will be realising the assets of the debtor under the security agreement as agent for the debtor. This should not

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[55] (1877) 2 App Cas 616 at 828-629.
[56] According to Riley's Bill of Exchange 3ed at p232, section 96 of the Bills of Exchange Act is founded on this distinction.
[57] Security Interests in Personal Property (1965) vol 2, p1234.
[58] *In re Kiamie's Estate* 309 NY 325, 330, 130 NE 2ed 745, 747 (1955).

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make a difference. The duty is further undermined if the obligations are secured over both personal property and land as a secured party may exercise the higher priority security under s117 and apply the law relating to land law decisions under s118(3).

Section 101 *Property Law Act 1958* (Vic) and s109(1) of the NSW Conveyancing Act (NSW) deal with the mortgagee's power of sale and set out the powers where the mortgage is by deed and empowers the mortgagee to sell in the manner provided as it thinks fit. Those powers are all that a mortgagee gets. Section 103 sets the requirement for notice before the power of sale becomes exercisable. Section 106(3) provides that the mortgagee is not responsible for involuntary loss.

The Transfer of Land Act (Vic) s77(1) uses the words 'in good faith' and having regard to the interests of the mortgagor or other persons. These words have not entertained much judicial comment but for *Henry Roach*[59] and most recently in *Nolan v MBF Investments Pty Ltd* [2009] VSC 244 (18 June 2009) where Vickery J put a gloss on the interests of the mortgagor because of the Human Rights Act (Vic).

General law duty in Australia

The good faith standard in *Pendlebury*[60] seems to represent the common law standard of care for a mortgagee in Australia and may be stated as imposing an obligation on a mortgagee to exercise his power of sale in good faith having regard to the interests of the mortgagee but not disregarding the interests of the mortgagor[61].

Croft and Johannsson[62] summarise the following matters as part of the mortgagee's duty:

---

[59] *Henry Roach (Petroleum) Pty Ltd v Credit House (Vic) Pty Ltd* [1976] VR 309.

[60] *Pendelbury v Colonial Mutual Life Assurance Society Ltd* (1912) 13 CLR 676.

[61] Croft and Johannsson *The Mortgagee's Power of Sale* 2ed (2004) at 145.

[62] *Op cit* at 144-145.

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1. the mortgagee is not a trustee.
2. a mortgagee is entitled to realise his security by selling the collateral as and when he chooses (subject to any notice requirement) except where the timing would cause manifest unfairness.
3. Power to be exercised in good faith taking into account the mortgagees interest but not ignoring those of the mortgagor.
4. Mortgagee is bound to obtainable the best price obtainable.
5. The mortgagee owes no duty that would make it liable for mere negligence or carelessness. The position appears to be different in New Zealand as a certain degree of negligence or carelessness might put the mortgagee in breach of it duty to obtain the best price.
6. The duties in relation to land registered land (Torrens title) are generally the same in relation to general law land. It is clear that the common law duty also extends to personal property and where the powers of sale is being exercised by a receiver the duty is owed to the creditors generally[63].

Obtaining a proper or fair price or fair market value of the property being sold is simply part of the duty to act in good faith. In *Latec Investments Ltd v Hotel Terrigal Pty Ltd*[64] Kitto J though that the mortgagee's duty of good faith was satisfied if the mortgagee took reasonable steps to obtain a fair value on sale.

In Canada, the general duty seems to be to take reasonable care to obtain the true market value[65]. True market value and proper price[66] seem to be one and the same thing[67].

In *Forsyth v Blundell* Menzies J said[68]:

---

[63] *Expo International Pty Ltd v Chant* [1979] 2 NSWLR 820.

[64] (1965) 113 CLR 265 at 273.

[65] *McHugh v Union Bank of Canada* [1913] AC 299 PC.

[66] Cf *Goldcel Nominees Pty Ltd v Network Finance Ltd* [983] 2 VR 257 where Murphy J thought that the statutory duty was to obtain the best price at 261-262.

[67] *Cuckmere Brick Co Ltd v Mutual Finance* [1971] Ch 949 Salmon LJ at 968. *Cuckmere* seems to have been accepted as the law in New Zealand by the Privy council in *Downsview Nominees Ltd v First City Corporation* [1993] AC 295 (as case dealing with receivers) but there is no negligence standard involved.

[68] *Forsyth v Blundell* [1973] HCA 20; (1973) 129 CLR 477 at 481.

"The rule to be applied here is not in doubt; it was stated authoritatively by Lord Herschell in the last century. In *Kennedy v de Trafford* (1897) AC 180, which has been followed by this Court in *Barns v Queensland National Bank Ltd* (1906) 3 CLR 945 and *Pendlebury v Colonial Mutual Life Assurance Society Ltd* [1912] HCA 9; (1912) 13 CLR 676, the Lord Chancellor said (1897) AC, at p185 :

"... if a mortgagee in exercising his power of sale exercises it in good faith, without any intention of dealing unfairly by his mortgagor, it would be very difficult indeed, if not impossible, to establish that he had been guilty of any breach of duty towards the mortgagor. Lindley LJ in the Court below, says that 'it is not right or proper or legal for him either fraudulently or wilfully or recklessly to sacrifice the property of the mortgagor.' Well, I think that is all covered really by his exercising the power committed to him in good faith. It is very difficult to define exhaustively all that would be included in the words 'good faith', but I think it would be unreasonable to require the mortgagee to do more than exercise his power of sale in that fashion. Of course, if he wilfully and recklessly deals with the property in such a manner that the interests of the mortgagor are sacrificed, I should say that he had not been exercising his power of sale in good faith".

I do not think that statements in some cases, such as *McHugh v Union Bank of Canada* (1913) AC 299 or *Cuckmere Brick Co Ltd v Mutual Finance Ltd* (1971) Ch 949, that the mortgagee is under a duty to take reasonable precautions to obtain a proper price, are at odds with the rule stated by Lord Herschell. *To take reasonable precautions to obtain a proper price is but a part of the duty to act in good faith.* This duty to act in good faith falls far short of the Golden Rule and permits a mortgagee to sell mortgaged property on terms which, as a shrewd property owner, he would be likely to refuse if the property were his own.

Matters that the Canadian and US courts take into account in determining whether a secured party has acted in a commercially reasonable manner include:

1. Preparing the collateral for disposition by repair: *Donnelly v International Harvester Credit Corp of Canada* (1983) 2 PPSAC 290;
2. Selling by public auction or tender or private sale;
3. Purchase of the property by the secured party only if the sale is by public auction or tender and only if the price bears a reasonable relationship to its market value.

There are a number of other factors and these as listed in Cuming Wood and Gedye.

Commercial reasonableness unlike good faith seems dependent on an understanding of what is considered reasonable by those involved in a particular industry or practice under scrutiny as opposed to a subjective understanding of a particular person whose conduct is in issue.

Guidance on this comes from Article 9 §9-627(6) which refers to:

(1) in the usual manner in any recognised market;
(2) at the price current in any recognised market at the time of sale (eg Red Book value for motor vehicles);
(3) otherwise in conformity with reasonable commercial practices among dealers in the type of property that was subject of the sale.

On balance commercial reasonableness seems to be something higher than good faith or honesty. Good faith equates to honesty but the sale must be in a commercially reasonable manner. Gilmore[69] suggests that this imposes an obligation to use every effort to sell under every possible advantage of time, place and publicity.

Consumer practices would seem to dictate that price is probably more important after compliance with the Uniform Credit Code. But in commercial matters correct procedures are probably more important as market conditions will dictate price more than anything else.

It is probably fair to say that the obligation to act in good faith or honestly in a commercially reasonable manner is a higher burden than that imposed on a mortgagee at general law and also by statute in relation to land.

The Bill's proposals in Chapter 4 that allow a secured party to use the land procedures where mixed collateral is involved will create problems. It is unreasonable to expect a secured party to have to follow two differing standards

[69] *Op cit*, Vol 2, 1233-1234.

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depending on whether the collateral is land or personal property, or if mixed choose the land procedures if the priority is higher. It is assumed that priority means first in time rather than value but it is more likely the draftsman meant value.

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Barrister
Owen Dixon West Chambers, Melbourne

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PPS: Specific Issues - Chaos In The Making.....

Patrick Lowden
Partner
Freehills
Sydney

PPS in Australia – specific issues

Aspects of taking security

Patrick Lowden

Freehills

Aspects of taking security

- Meaning of “security interest”
- Creation of the interest in the “collateral”
- Taking steps to protect the interest from subsequent extinguishment or loss of priority

Meaning of ‘security interest’

- Section 12(1):

  an interest in relation to personal property provided for by a transaction that, in substance, secures payment or performance of an obligation (without regard to the form of the transaction or the identity of the person who has title to the property).

Meaning of ‘security interest’

- ‘Functional’ approach
- Ambiguity
  - an interest that is provided for by a transaction AND in substance secures payment, etc; or
  - an interest that is provided for by a transaction THAT in substance secures payment, etc.
- Uncertainty
  - Meaning of ‘in substance’
  - Leases
  - ROT
  - Subjective

Deemed security interests

- Section 12(3): certain interests deemed to be security interests
- Principally:
    - the interest of a transferee of an ‘account’ or ‘chattel paper’;
    - the interest of a consignor under a commercial consignment; and
    - the interest of a lessor under a lease for more than 12 months
- Continued importance of general definition

Creating security interests

- Section 18 - 20
- Section 18: Effectiveness of security agreements

    A security agreement is effective according to its terms.

Creating security interests

- Section 19: Enforceability against the grantor
- subsection 19(1): 'a security interest is enforceable against a grantor in respect of particular collateral only if the security interest has attached to the collateral'; and
- subsection 19(2): 'a security interest attaches to collateral when:

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

  (b) either:

    (i) value is given for the security interest; or

    (ii) the grantor does an act by which the security interest arises.'

Creating security interests

- Section 20: Enforceability against third parties

  A security interest is enforceable against a third party in respect of particular collateral only if:

  (a) the security interest is attached to the collateral; and

  (b) one of the following applies:

  (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).

Formalities

- Section 20(2)

  A security agreement covers collateral in accordance with this subsection if:

  (a) the security agreement is evidenced by writing that is:

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

  (ii) adopted or accepted by the grantor by an act specified in the writing that is done with the intention of adopting or accepting the writing; and

  (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.

Who is the 'grantor'?

(a) a person who owns the personal property, or has the interest in the personal property, to which a security interest is attached (whether or not the person owes payment or performance of an obligation secured by the security interest); or

(b) a person who receives goods under a commercial consignment; or

(c) a lessee under a PPS lease; or

(d) a transferor of an account or chattel paper; or

(e) a transferee of, or successor to, the interest of a person mentioned in paragraphs (a) to (d); or

(f) in relation to a registration with respect to a security interest:

(i) a person registered in the registration as a grantor; or

(ii) a person mentioned in paragraphs (a) to (e).

Correspondence to other PPS regimes – a code or not?

- Overseas models constitute a code for the creation of security interests:
  - a security agreement is effective according to its terms;
  - such an agreement, or the interest created by it, is also effective against third parties, subject to the grantor having “rights” in the collateral
- Australian position unclear
- Definition of ‘security agreement’
- Section 257: Relationship between Australian laws

  Subsection 18(1) is subject to each of the following laws:

  (a) a law of the Commonwealth (other than this Act);

  (b) a law of a State or a Territory;

  (c) the general law.

Nemo dat: Just a flesh wound?

- *Nemo dat* principles not applicable under overseas models
- Indications that the principle survives in the Australian bill
  - section 257: preservation of general law
  - definition of ‘grantor’
  - section 112

Perfecting security interests

- Not defined in conceptual terms – just prescribed steps
- Importance of perfection
  - Extinguishment rules
  - Priority rules
  - Validity in bankruptcy / winding up
- Modes of perfection:
  - Registration
  - Possession
  - Control

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PPS: Specific Issues - Chaos In The Making.....

Steve Flynn
Special Counsel
Simpson Grierson
Wellington

PPSA in Australia – Chaos in the Making, or Brave New World?

PPSA Implementation Issues – Some New Zealand Experiences

Simpson Grierson

Steve Flynn

Simpson Grierson

Wellington

1 August 2009

*On 2 July 2009, the Council of Australian Government (**COAG**) agreed that PPS reform should be implemented in May 2011 ... COAG has agreed that legislation supporting the reform should be in place in 2009 and that the IT framework should be in place by May 2010 ... These measures mean that business and consumers will have **twelve months** to prepare for the reform.*

Hon Robert McClelland

Attorney-General

Canberra

8 July 2009

Some Numbers....

	New Zealand	Australia
Population	4.4 million	21.8 million
Banks*	19	~ 57
Bank* loans	NZ$294 billion	A$1,451 billion
Political divisions	1	Federal plus 8
PPSA	32,600 words	69,200 words
Implementation period	30 months	12 to 18 months

* Not including other forms of lender

Simpson Grierson

Implications – Education and Systems

- a new way of thinking about "secured" transactions
- extensive education and training implications for advisers, lenders and other participants
- marketing opportunities/threats for advisers
- review and rewriting of policies, procedures, manuals – industry examples
- systems implications – design, registration, searching, storage

Simpson Grierson

Implications - Documentation

- review and revision of all lending/security/ancillary documents
- collateral advantages
- breadth of review – examples of ancillary documents
  - deeds of priority/subordination
  - negative pledges
  - swaps and repos
- other participants' documents

Implications - Transitional

- adequacy of pre-NZPPS documents
- portability of existing registrations
- newly-registrable transactions
- transitional period – co-existent regimes

Conclusion

It's been worth it.

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31 July -1 August 2009

Saturday 1 August
11:35am – 12:50pm

NZ Finance Companies "The Way Forward"

Chair:
Dennis Church
General Manager - Corporate Trustee Services, Public Trust, Auckland

Speakers:
Grant Graham
Partner, KordaMentha, Auckland

Clynton Hardy
Chairman, Trustee Corporations Association of New Zealand Inc, Wellington

Ian Woolford
Manager, Financial System Policy, Reserve Bank of New Zealand

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NZ Finance Companies "The Way Forward"

Grant Graham
Partner
KordaMentha
Auckland

KordaMentha

NZ Finance Companies

The Fallout and Lessons for Go Forward

Grant Graham
KordaMentha

Agenda

1. Economic Climate pre 2006
2. The Roll Call
3. Common features in collapses and lessons for the future

Economic climate pre 2006

Extraordinarily good and prolonged period of economic growth and confidence in New Zealand.

Economic climate pre 2006 (cont.)

NZX Market Movement vs Time

Economic climate pre 2006 (cont.)

GDP per capita

Economic climate pre 2006 (cont.)

KordaMentha

- Growth and easy access to money meant little home for equity.
- Lower bank interest rates meant increasing support for investment alternatives.
- Relative low stress entry meant the numbers of finance companies grew dramatically.
- Finance was suddenly available to those who had never had access to it before.

"The Roll Call" – Three waves of failure

- Motor Vehicle Financiers (mid 2006)
- Consumer Lending (mid 2007)
- Property Financiers (late 2007, 2008)

2006 – 3 motor vehicle failures

1. National Finance 2000 ((R) May 2006)
   - Secured Investors owed $25.5m

2. Provincial Finance ((R) June 2006)
   - Secured Investors owed circa $300m

3. Western Bay Finance ((R) August 2006)
   - Secured Investors owed $48m

2007

KordaMentha

4. Bridgecorp ((R) July 2007)
   - Owed circa $500m to 18,000 investors
5. Nathans Finance ((R) August 2007)
   - Owed $166m to 6,000 investors
6. Property Finance ((R) August 2007)
   - Secured debentures of $80m – came out of receivership in February 2008
7. Five Star Consumer Finance ((R) August 2007)
   - Owed $58m
8. LDC Finance ((R) September 2007)
   - Owed $19.3m to 995 depositor and debenture holders.

2007 (cont.)

9. Finance & Investments ((R) September 2007)
   – Owed $16m to 370 investors.

10. Clegg & Co Finance ((R) October 2007)
    – Has around $15m of 500 investors' funds in debentures.

11. Beneficial Finance ((M) October 2007)
    – Has $24.2m of investors' funds.

12. Geneva Finance ((M) October 2007)
    – Owed $138m to 3,000 creditors.

13. Capital + Merchant Investments ((R) November 2007)
    – Owed $190m to 7,000 investors.

14. Numeria Finance ((R) December 2007)
    – Owed $6.4m to 480 debenture holders

2008

KordaMentha

15. MFS Boston ((M) March 2008)
    – Owed $38.5m to 1,700 investors.

16. Lombard Finance and Investments ((R) April 2008)

    – Owed $10m to 4,400 investors.

15. Kiwi Finance ((R) April 2008)
    – Owed $2m to investors.

16. Cymbis New Zealand ((R) May 2008)
    – Owed $6.9m to 797 stockholders.

19. MFS Pacific Finance ((M) May 2008)
    – Owed $300m to stockholders.

2008 (cont.)

20. Belgrave Finance ((R) May 2008)
    - Owed $22m to about 1,000 debenture investors
21. IMP Diversified Fund ((M) June 2008)
    - Owed $16.5m to debenture holders.
22. Dominion Finance Holdings ((R) June 2008)
    - Owed $276m to debenture holders.
23. St Laurence Ltd ((M) June 2008)
    - Owed $240m to 9,000 debenture holders

2008 (cont.)

24. Dorchester ((M) June 2008)
    - Owed $168m to debenture stock investors and $8m to subordinated noteholders.
25. North South Finance ((M) December 2008)
    - Owed $102m to 3,800 investors.
26. Strategic Finance ((M) December 2008)
    - Owed $325m to 15,000 investors.
27. Hanover Finance ((M) December 2008)
    - Owed $465m to 13,000 investors.
28. United Finance ((M) December 2008)
    - Owed $65m to 2,400 investors.

2009

29. Compass Capital ((R) March 2009)
    – Owed $14m to secured investors.
30. Mascot Finance ((R) March 2009)
    – Owed $65m.
31. Orange Finance (M?) August 2009)
    – Owed $25m to 1,500 investors.

Some unbelievable outcomes

	Book $m	# Investors	¢ in $
▪ Bridgecorp	500	18,000	>10¢
▪ Capital + Merchant	190	7,000	0!
▪ Nathans	166	6,000	>10¢

Outcry – So far …

KordaMentha

Banning Orders/ Charges laid in relation to:

- Bridgecorp
- Five Star Finance
- Nathans
- National Finance 2000 (Director and Auditor)
- Clegg & Co

… Watch this space

So what were the features that contributed to this meltdown?

i. A number of low quality directors – predominance of executive directors.

ii. Often poor or non-existent due diligence by investors – primarily rate responsive.

iii. A regime that did not require financial advisers to disclose commissions received from finance company placements.

iv. Poor quality trust deeds that allowed for excessive related party lending.

v. A complete disconnect between market perception of role of Trustee and actual role.

So what were the features that contributed to this meltdown? (cont.)

vi. In a Trustee industry of 5 participants, 2 players assumed circa 80% of the market by number of appointments.

vii. A reactive (rather than proactive) regulatory regime.

viii. Widespread practice of rollover or new loan to mask existing problems.

ix. Predominance of 2nd tier auditors.

2nd tier auditor predominance in failures

Auditor	Failures
O'Halloran & Co	1
Ingham Mora	1
PKF	2
Staples Rodway	3
BDO	9
Sherwin Chan & Walshe	2
Hayes Knight	2
Silks	1
Markhams	1
Grant Thornton	2
Martin Wakefield Ltd	1

‘Big 4’ finance company audit failures

PwC	1
Deloitte	0
Ernst & Young	1
KPMG	4

Profile of "Next Time Around"

- Quality Directors
- Disclosed Broker Commissions
- Robust Audits
- Ratings ?
- "Real role" for Trustees

- Key word … **TRANSPARENCY**

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NZ Finance Companies
"The Way Forward"

Clynton Hardy
Chairman
Trustee Corporations Association of New Zealand Inc,
Wellington

TCA

TRUSTEE CORPORATIONS ASSOCIATION of NEW ZEALAND

STRENGTHENING THE CORPORATE TRUSTEE REGIME

Clynton Hardy,
Chairman of the Trustee Corporations Association of NZ Inc.

TCA

TRUSTEE CORPORATIONS ASSOCIATION of NEW ZEALAND

Members of the TCA

Perpetual Trust

Trustees Executors

One Associate Corporate Trust Member

Covenant Trustee Company

- **We accept the need for change**
- **We can be more effective**
- **We have a plan !**

The need for change

- Inconsistent levels of capability
- Inconsistent approaches to trust deeds
- Inconsistent reporting
- Lack of transparency and accountability
- Hamstrung regulators

A new Corporate Trustee Model:

1. Licensing
2. Supervision
3. Accountability

1. Licensing

- **Registered by Securities Commission**
- **Trustees lose statutory right**
- **Approval criteria, eg**
  - independence
  - experience
  - fit and proper character

2. Supervision

- Have power to monitor licence
- “Licensed” Trustee to regularly report
- Must report any trust deed breaches

3. Accountability

- Sanctions and penalties eg
  - suspension from issues
  - revocation of licence

Benefits

- **Robust supervision:**

  - ensures Trustees are capable
  - gives Securities Commission power

- **Accords with IMF and World Bank**

- **Gives investors confidence**

The way forward

- No major legislative change required
- We are determined to lift our performance
- We have a practical and effective plan

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NZ Finance Companies
"The Way Forward"

Ian Woolford
Manager
Financial System Policy
Reserve Bank of New Zealand

RESERVE BANK
OF NEW ZEALAND

Establishing a new NBDT Regime in New Zealand

Presentation to
Banking & Financial Services Law Assn
July 2009

Ian Woolford
Reserve Bank of New Zealand

Non-bank deposit takers landscape

- **NZ NBDTs: 106 in total**
  - **Credit Unions: 31**
  - **Building Societies 9**
  - **Finance Companies 66**
- **AU ADIs: 193 in total**
  - **Includes Banks and specialised firms, but excludes Finance Companies**
  - **Credit Unions 118**
  - **Building Societies 11**
  - **Banks and payment providers (64 all together)**

Challenges in the Non-Bank Sector

At Dec 08	Hh Financial Assets	Failures & Suspensions
Banks	$90bn	-
Managed funds & trusts	$51bn	4%
Finance coys, savings institutions	$9bn	30%
Total	$150bn	3%

Background to law change

- RBNZ raised concerns about sector 2003
- 2004 Financial Sector Assessment Programme
- Number of failures in sector 2007

RBNZ Amendment Bill #3

- Introduced new Part 5D
- For the purpose of:
  - A sound and efficient financial system; or
  - Avoiding significant damage..from failure of NBDT
- Extended trustees as the ‘frontline’ supervisors
- Requires a review within 5 years

Part 5D of RBNZ Act

- **Requires NBDTs to have:**
  - **a risk management plan (September 2009)**
  - **a credit rating (March 2010)**
  - **appropriate governance arrangements (not in force)**

Part 5D of RBNZ Act

- **Enables regulations:**
  - **Capital requirements (Q3 2010)**
  - **Related party requirements (Q3 2010)**
  - **Liquidity requirements (Q3 2010)**

Establishing the regime

- So far consulted on requirements for:
  - Capital;
  - Related Party;
  - Credit Ratings; and,
  - Risk management.

‘Second’ Bill to come

- **Main components**
  - **Licensing powers for RBNZ**
  - **Fit and proper powers**
  - **Crisis management powers**
- **To be introduced this year**

Section 157C

- **Section 157C defines a (Non-bank) deposit taker:**
  - **Offers debt securities to the public in NZ; and**
  - **Carries on the business of borrowing and lending, or providing financial services, or both.**
- **Enables the RBNZ to declare a person or class of persons to be a NBDT**

157C issues

- **Deliberately wide**
- **Raises ‘boundary’ issues:**
  - **Corporate bond issuers**
  - **‘Conduit’ issuers**
  - **Payment providers**
  - **Australian (and other) issues to NZ market**
  - **‘Moratoria’ companies**
  - **Companies without trust deeds**

RBNZ Approach

- **Exemption powers**
  - **In part or in whole**
- **On the other side 'get in' powers**
- **Extensive policy development on boundary issues**
- **And subsequent communication**

Non-bank deposit takers
Insurance sector
Payment system oversight
Financial Stability Report
Publications & research
News releases
Speeches
Payments & settlements
Financial market operations
Crisis management
For schools
Careers
Frequently asked questions

RBNZ Policy Positions

It will often be straightforward to determine whether an entity meets the definition of a non-bank deposit taker for the purposes of Part 5D of the Act. However there may be situations where the law is not so clear-cut, or where the law does appear to apply. In this regard the Reserve Bank will provide general guidance on such matters where it is considered appropriate (especially in the transitional stages of the regime). This guidance is detailed in the table below. The table will be updated from time to time to reflect any development or change in the Reserve Bank's policy stance.

The Reserve Bank wishes to emphasise that it is a matter for an entity to seek its own legal advice on the application and operation of the law, and it is the Court ultimately that is the final arbiter when it comes to this. Moreover, this table illustrates the Reserve Bank's general policy position, although any application for an exemption will be considered on a case-by-case basis.

Category	RBNZ policy positions (updated June 2009)
Corporate issuers	Corporate issuers such as manufacturing companies or utility providers that issue bonds, debentures or other debt securities and that carry on non-financial business are generally not considered by the Reserve Bank to be deposit takers.
Funding conduits	A genuine funding conduit may be exempted subject to conditions (upon application to the Reserve Bank) from related party, governance, risk management, liquidity and minimum capital ratio requirements, but not the credit rating requirement. To be eligible for these exemptions a funding conduit is expected to have all of the following attributes: • it is a wholly owned subsidiary; • its primary purpose is to on-lend all (or at least 95%) of the funds raised to its parent or group; • its debt securities are unconditionally guaranteed by its parent; • the parent is party to a listing agreement with a registered exchange and has an established presence or track record in the market it operates in; and • neither the parent nor any member of the group is a financial institution (as defined in the Act).

Payment facility providers	A genuine payment facility provider may be exempted subject to conditions (upon application to the Reserve Bank) from all the non-bank deposit taker requirements.
	In order to be eligible for an exemption, a payment facility provider is expected to have all of the following attributes:
	• It does not provide any other financial service apart from that of a payment facility;
	• Its payment facility:
	  • is a call security, i.e. the balance is repayable on demand;
	  • can be used in a similar way to cash, i.e. to make payments for goods and services;
	  • does not pay interest to the holder of the payment facility; and,
	  • does not form part of another financial product e.g. the facility cannot be used by the holder to obtain credit.

Entities exempted under the Securities Act 1978	The following provisions of the Act require non-bank deposit takers to meet regulatory requirements that are imposed through trust deeds (once relevant regulations are in force): • Section 157P which relates to minimum capital; • Section 157S which relates to a capital ratio (regulations are expected to be promulgated in 2009); • Section 157V which relates to a maximum limit on exposures to related parties (regulations are expected to be promulgated in 2009); • Section 157Z which relates to liquidity requirements (regulations are expected to be promulgated in 2010). These sections apply to all non-bank deposit takers notwithstanding that they are exempt from having a trust deed for the purposes of the Securities Act. Non-bank deposit takers that fall within this category must either: • adopt a trust deed in a manner that complies with both the Securities Act and the Act; or • apply to the Reserve Bank for an exemption from those sections listed above.

In addition, the Reserve Bank is currently working on the following class exemptions to give effect to policy decisions relating to specific classes. In general terms these two exemptions are:

a. a class exemption from the credit rating requirements (s.157I) for non-bank deposit takers with total liabilities of up to $20 million (the exemption will provide greater detail on how this is to be calculated);
b. a class exemption in relation to s.157N: the requirement to have a risk management programme signed off by a trustee. The class exemption will allow non-bank deposit takers that do not have a trust deed or trustee to obtain sign off for their risk management programme from an alternative governing body (the class exemption will define what an acceptable alternative governing body will be). This is not an exemption from having a risk management programme as required under s157M.

It is anticipated that both these class exemptions will be in place by the end of August 2009. The class exemptions will contain terms and conditions that must be met before an entity can rely on the class exemption.

Obligations on trustees

- Ensure requirements in trust deeds
- Attest to compliance
- Disclose information
- Hefty penalties – up to 200k

Looking forward

- **Five year review – trustee focus For most NBDTs regulations are manageable**
- **Exemptions will be the exception**
- **Bigger issues loom for some:**
  - **funding post DGS**
  - **Public confidence in pre-crisis business model**

The 26th Annual Banking and Financial Services
Law and Practice Conference

Sheraton Mirage Resort, Gold Coast

31 July -1 August 2009

Saturday 1 August
1:30pm – 2:45pm

Indefeasibility and All Advances Mortgages: Are they a thing of the past?

Chair:
Mariette van Ryn
General Manager, Regulatory Affairs, Customer Advocacy & General Counsel
Westpac New Zealand Limited, Auckland

Speakers:
Emeritus Prof. Peter Butt
School of Law, Sydney University, Sydney

Hon. Justice Margaret Stone
Federal Court of Australia, Sydney

Michael Robinson
Partner, Simpson Grierson, Auckland

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Indefeasibility and All Advances Mortgages: Are they a thing of the past?

Emeritus Prof. Peter Butt
School of Law
Sydney University
Sydney

"Indefeasibility and All Advances Mortgages: Are they a thing of the past?"

Part 2 – The recent cases

Some thoughts on mortgages and covenants to pay

© Peter Butt

I take as my text the question: "Indefeasibility for what?" This now-hallowed query, first asked by Campbell J in the New South Wales Supreme Court in *Small v Tomassetti* (2001) 12 BPR 22,253, has acquired quasi-Biblical proportions. Like a catchcry challenging religious orthodoxy, it has provoked a serious re-thinking of some fundamental propositions of the Torrens religion. It the years since its annunciation, it has been echoed on many occasions. Tillich-like, it has shaken Torrens' very foundations. It has forced a genuine reconsideration of the protection that a registered mortgagee of Torrens title land may expect under a forged mortgage.

In the first part of this seminar, Justice Margaret Stone has reminded us of the general principles of indefeasibility—in particular, the principle that even a forged document, on registration, achieves immediate indefeasibility. I want to concentrate on indefeasibility and forged mortgages—especially "all advances" or "all moneys" mortgages.

The "old style" mortgage

The past few years have seen an explosion in the number of forged-mortgage cases. Had the mortgages been of the "old style", securing a fixed sum that was stated in the mortgage, then there could have been little room for argument over the effect of registration. *Frazer v Walker*, part of our Australian and New Zealand heritage, would have ensured success for the mortgagee.

By "old style", I mean a mortgage worded along the following lines:

> "I [name] (hereinafter called the Mortgagor) … in consideration of $100,000 (hereinafter called the principal sum) lent to the Mortgagor by [name] (hereinafter called the Mortgagee), the receipt whereof is hereby acknowledged, do for the purposes of securing the principal sum … hereby

> mortgage to the Mortgagee the following land …[and there follow clauses specifying matters such as interest, payment dates and payments amounts].

In this form of mortgage, the mortgage *document itself* contained the contents of the mortgagor's covenant to pay, specifying

- the amount lent; and
- the repayment obligations.

Frazer v Walker, and the spate of forged mortgage cases that soon followed on both sides of the Tasman, established unequivocally that registration of a mortgage in this form ensured indefeasibility for the mortgagee (assuming, of course, no fraud by the mortgagee). Not a single judge dissented from this line of authority (except for a slight wobble when some Victorian decisions favoured a return to deferred indefeasibility). This was even though several statements in the words I have quoted from the "old style" mortgage were clearly false: (1) the consideration of $100,000 was not lent to the Mortgagor (rather, it was paid to the forger, who had probably absconded with it); and (2) the Mortgagor did not "acknowledge receipt" (because his or her signature was forged). Nevertheless, indefeasibility rendered those statements unchallengable.

Despite the unanimous result in these cases, there was room for argument over whether registration of a forged mortgage strictly rendered indefeasible the (forged) covenant to pay. The majority of judges held (or at least assumed) that it did. But other judges, including the New Zealand Court of Appeal in *Duncan v McDonald* [1997] 3 NZLR 669, held that registration secured only the mortgagee's charge over the land, and that the personal covenant to pay operated only to measure the amount by which the land stood charged. For example, the mortgagee could not sue the (real) mortgagor in debt under the personal covenant, because that covenant was in a forged document and so did not bind the (real) mortgagor. Registration made no difference to that. Registration meant that the mortgagee could sell the land; but if the sale proceeds were insufficient to pay out the debt, the mortgagee had no recourse to the (real) mortgagor for the deficiency. These matters are discussed in an excellent

survey by Stoljar, "Mortgages, indefeasibility and personal covenants to pay" (2008) 82 ALJ 28.

All moneys mortgages

In more recent times, however, mortgages for fixed, stated sums seem to have largely disappeared from banking practice. They have been replaced by the "all moneys" mortgage. And with that change in practice has come a change in legal analysis. The courts have held, almost universally, that registration of a forged "all moneys" mortgage does not guarantee success for the mortgagee.

A recent decision in New South Wales analyses most (but not all) of the recent cases: *Perpetual Trustees Victoria Ltd v English* [2009] NSWSC 478 (Simpson J). I will not repeat that review here. In any case, as her Honour points out in *English*, much turns eventually on the terms of the particular mortgage. Instead, I will discuss the case which I think is the key to understanding the current position—*Printy's* case—and then try to draw some conclusions about the present state of the law.

Provident Capital Ltd v Printy [2008] NSWCA 131

Mr Printy owned land in outer Sydney. Unbeknowns to him, a rogue persuaded the Registrar-General to issue him (the rogue) with a certificate of title for the land. Armed with the certificate of title, the rogue then posed as Mr Printy and forged Printy's signature on two mortgages over the land. By the time Mr Printy discovered the fraud, the mortgagee had exercised its power of sale under each mortgage. Mr Printy sought to recover from the mortgagee the amounts appropriated from the sale to pay out the mortgages.

One mortgage (the first mortgage) was an "all moneys" mortgage. The other mortgage (the second mortgage) was in the "old style".

As with other "old style" mortgages, the second mortgage secured a stated sum. To be precise, that sum was not stated to in the mortgage itself, but was stated in a memorandum, and the mortgage expressly incorporated the terms of the

memorandum. The mortgagee conceded (and the trial judge clearly agreed: see [2007] NSWSC 287 at [45]) that registration of the mortgage cured the forgery. The mortgagee was entitled to retain the amount appropriated for this mortgage. This was simply *Frazer v Walker* all over again—the application of accepted principles of indefeasibility.

The position regarding the first mortgage was, however, more difficult. It also incorporated a registered memorandum. However, that memorandum did not refer to any specific sum or any specific payment obligations. Rather, it referred to obligations under "related agreements", but those related agreements were not incorporated into the memorandum. In essence, it provided that:

1. the mortgagor must pay the "secured money" as provided in any "related agreement";
2. "secured money" means all money which the mortgagor owes to the mortgagee now or in the future;
3. "related agreement" means any agreement under which the mortgagee lends money to the mortgagor.

As Basten JA noted (speaking for the Court of Appeal), since the mortgage and the memorandum had been forged, the mortgagor could not be liable to pay the moneys at common law. Any liability must turn on the effect of registration of the mortgage. And then follows the nub of the judgment (at [43-47]):

1. registration of a mortgage confers indefeasibility on the covenant to pay where the covenant to pay (that is, the amount owing and the repayment obligations) is contained in the mortgage (including a covenant contained in another document, <u>if</u> that other document is incorporated into the mortgage); but
2. registration of a mortgage does <u>not</u> confer indefeasibility on a covenant to pay contained in a document that is separate from (and not incorporated into) the mortgage.

Had the mortgagee under this first mortgage been entitled to sell the land? The mortgagee had purported to sell under section 57 of the NSW *Real Property Act* (a

provision with counterparts in all Australian jurisdictions). That section authorised a sale in either of two situations:

1. "default in the payment, in accordance with the terms of the mortgage … of [money] the payment of which is secured by the mortgage". But there was no payment in accordance with the terms of the mortgage – because the mortgage itself did not contain terms specifying the amounts of and times for payment ([2008] NSWCA 131 at [50]); or
2. "default in the observance of any covenant in the mortgage". But there was no such default, because the relevant obligation to pay was found not in the mortgage, but in the separate loan agreement, which was not incorporated into the mortgage. (Here I remind you that the memorandum *referred to* "related agreements", but did not incorporate them.)

So there you have it: the problem for the mortgagee under the forged all moneys mortgage in *Printy* was that the "related agreements" (under which moneys were advanced to the rogue, and the rogue promised to pay) were not "incorporated into the mortgage". Or as Simpson J put it in *English* at [110]:

> [In *Printy*], because the deed of loan could not be read as part of the mortgage, and was not expressly incorporated, its terms could not properly be described as "covenants, agreements or conditions expressed in the mortgage". The debt the subject of the loan was not secured by the mortgage.

The New Zealand Court of Appeal later came to the same conclusion, applying the same logic: *Westpac Banking Corp v Clark* [2008] NZCA 346. On the facts before it, the NZCA held that the (forged) loan agreement had not been incorporated into the registered mortgage. Specifically, the NZCA said, in relation to *Printy* (as decided at first instance):

> "In *Printy* (SC), [the trial judge] … accepted that it would have been open to the lender in that case to fashion the mortgage obligations so as to make the mortgagor liable not only for his own conduct but for the dishonest conduct of others over whom the mortgagor had no control. However, he considered that

> the "clearest possible expression would have been needed to achieve that effect". Such clear expression was not to be found in the subject mortgage [in this present NZ case]".

That is, the Court recognised that all moneys mortgages could be effective, even when forged, if the collateral loan agreements are incorporated into the registered mortgage.

Incorporating loan agreements into the mortgage

It seems, then, that forged all moneys mortgages can be protected by registration as much as "traditional" stated-sum mortgages, if the loan documents under which moneys are advanced are "incorporated into" the mortgage. A recent Victorian decision is an example: *Solak v Bank of Western Australia Ltd* [2009] VSC 82 (which does not seem to have been cited to Simpson J in *English*). That was also a case of a forged mortgage and forged loan agreements. The rogue had impersonated the registered proprietor (Mr Solak). However, unlike *Printy* and some of the other cases, here the judge (Pagone J) was able to hold, as a matter of construction, that the mortgage sufficiently incorporated the (forged) loan agreement. And having been incorporated, registration of the mortgage ensured the mortgagee's right to recover. The logic was:

1. the mortgage expressly incorporated a memorandum of common provisions filed at the Land Titles Office;
2. that memorandum required payment by the mortgagor (called "you") in accordance with the terms of any "Bank Document"
3. the term "Bank Document" was defined to include any document under which "you" incur obligations to the bank;
4. that the "you" referred to was the same "you" as in the memorandum;
5. that "you" was in fact the person who signed all the documents (that is, the forger, impersonating the registered proprietor); and
6. therefore, the position was the same as if the memorandum had described the registered proprietor (Mr Solak) by name.

Pagone J concluded (at [16]):

> I consider the proper construction of the mortgage[in this case] to be that the covenant to pay is found in the mortgage, incorporating, as it does, the memorandum of common provisions and, through it, the [loan contract]. Accordingly, the mortgage, albeit forged, is effective as security. This conclusion is, in my view, consistent with the authorities relied upon for Mr Solak. The contrary outcomes in each of *Printy* [and two other cases, at first instance, *Chandra* and *Tsai*] depended upon the collateral agreement not having been incorporated into the mortgages. … In the case before me the mortgage document refers to, incorporates, and intends to incorporate, the obligations in the collateral document upon the stated assumption expressed in all three agreements that the person assuming the obligation and mortgaging the property is the same.

So, Pagone J held that it is possible to incorporate into the registered mortgage all of the documents relating to the loan—including, critically, those documents that contain the covenant to pay.

Mismatch between identities of forger and mortgagee—they are not the same person

Assuming an effective incorporation into the mortgage, there seems to be another problem for mortgagees, highlighted in particular by two New South Wales decisions (*Chandra v Perpetual Trustees Victoria Ltd* [2007] NSWSC 694 and *Vella v Permanent Mortgages Pty Ltd* [2008] NSWSC 505). In outline, it is this:

- as a result of the incorporation of the loan agreements, the mortgage secures all moneys advanced to the "mortgagor" or "to me" (ie, the "real" mortgagor – the registered proprietor) under the loan agreements;
- but the loan agreements are signed by the forger, not the real mortgagor, and so there is in fact no money advanced to the "mortgagor" or "to me" under them;
- therefore, the mortgage secures nothing.

Pagone J in *Solak* holds that, as a matter of construction, the mismatch between the forger and the real mortgagor can be overcome. But the NSW decisions hold, at least on the wording in the particular documents, that the mismatch is an insuperable obstacle for the mortgagee.

Overcoming the mismatch

Presumably, such a mismatch can be overcome by effective drafting. Here, as in drafting generally, it is better to be blunt than subtle. The aim is to make clear beyond argument that the mortgage intends to capture all documents that a forger might sign in relation to the property. If we were to be brutally blunt, the relevant clause in the mortgage could be drafted along the following lines:

1. This mortgage secures all moneys we advance on the security of this property, under any loan agreement to which we are a party, regardless of who signs the loan agreement and regardless of who receives the money.
2. Any such loan agreement (whether made before, at the same time as, or after the date of this mortgage) is hereby incorporated into and is to be read as part of this mortgage.

To state the obvious, such a blunt clause is unlikely to promote public confidence in lenders. Inevitably, it would be tested in court. And so I add the necessary rider that you should not rely on my suggestion or my drafting, but make your own independent assessment of the case law and the relevant statutes.

An alternative view?

Under the case law to date, the crucial point seems to be the need to incorporate the (forged) loan agreement into the forged but registered mortgage. If that is done, the mortgagee's rights may secured; if it is not done, they are not secured.

But I wonder if a wider view is possible? It would be based on the argument that (1) registration of the (forged) mortgage secures an indefeasible *charge* over the property,

but (2) the obligations the charge *secures* is a matter of evidence. Let me illustrate in two steps:

1. In an "old style" mortgage, the *statement* in the mortgage of the amount secured is only a first step to establishing *how much* is in fact secured. No mortgagee would be allowed to recover the stated sum just because the mortgage stated the sum. The mortgagee would have to call evidence as to how much was actually advanced, how much has been repaid to date, and so on; only then could a court determine how much remained owing. Those facts are necessarily established outside of the mortgage document itself.

2. Now let us consider the "all moneys" mortgage, of the kind discussed in the recent cases. Registration of the (forged) mortgage validates the mortgagee's charge. To establish the amount secured by the charge, we need to call evidence of how much was actually advanced, how much has been repaid to date, and so on. This requires evidence extrinsic to the mortgage, just as in the "old style" mortgage. In this regard, why should it matter that the amount advanced is indicated in documents that are not incorporated into the registered mortgage? It is simply a question of evidence, as in the case of the "old style" mortgage. That is, the crucial point is that the mortgage is registered; the fact that the amount secured can only be established by documents dehors the mortgage should not matter.

As I understand it, an argument to that effect was put recently to the New Zealand Supreme Court in an appeal from *Westpac v Clark* [2008] NZCA 346. The argument involves departing from the approach in *Printy* and the other *Printy*-like decisions. I will leave it to our next speaker to outline what the Supreme Court decided.

Peter Butt
1 August 2009

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Indefeasibility and All Advances Mortgages: Are they a thing of the past?

Hon. Justice Margaret Stone
Federal Court of Australia
Sydney

FEDERAL COURT OF AUSTRALIA

Indefeasibility and All Advances Mortgages

Are they a thing of the past?

Part 1 – The problem and the principles

Margaret Stone

26th Annual Bank & Financial Services Law Conference 2009

Deferred and Immediate Indefeasibility

A → C

Transfer forged by B

C → D

D

Registered proprietors

Frazer v Walker

[1967] 1 AC 569

Mr & Mrs Frazer

Registered proprietors of fee simple

→ Mortgage £3000
Mr Frazer's signature forged

Mr & Mrs Radomski

Registered proprietors of mortgage

↓ sale under power of sale

Mr Walker

Registered proprietor of fee simple

[T]heir Lordships have accepted the principle that registration … confers upon a registered proprietor a title to the interest in respect of which he is registered which is … immune from adverse claims, other than those specifically excepted.

Frazer v Walker [1967] 1 AC 569 at 585

[T]his principle in no way denies the right of a plaintiff to bring against a registered proprietor a claim *in personam*, founded in law or in equity, for such relief as a court acting *in personam* may grant.

Frazer v Walker [1967] 1 AC 569 at 585

Breskvar v Wall

(1971) 126 CLR 376

E & F Breskvar

Registered proprietors of fee simple

void transfer*

G Petrie

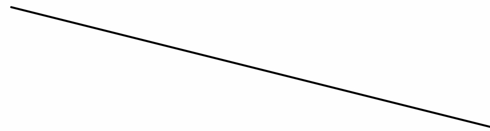
(unreg. transfer)

G W Wall

Registered proprietor of fee simple

sale

Caveat lodged – blocked registration of Alban's transfer



Alban Pty Ltd

*Failure to insert name of transferee prior to execution; *Stamp Act 1894* (Qld) s53(5)

The Torrens system of registered title of which the Act is a form is not a system of registration of title but a system of title by registration …

The title it certifies is not historical or derivative. It is the title which registration itself has vested in the proprietor.

Beskvar v Wall (1971) 126 CLR 376 at 385-6 per Barwick CJ.

Breskvar v Wall

(1971) 126 CLR 376

- Alban Pty Ltd acquired an equitable interest in the land.
- Breskvar had equitable claim (mere equity or equitable interest) to have transfer to Wall/Petrie set aside.
- Resulting competition between Alban and Breskvar resolved in favour of Alban on equitable principles.

Vassos v State Bank of SA

[1993] 2 VR 316

P, A & T

Registered proprietors

as tennants in common

T forged mortgage

$500,000

Bank

Registered proprietor of mortgage

T also forged signatures of P & A on guarantee and indemnity

Vassos v State Bank of SA

[1993] 1 VR 316

The mortgage secured:

"all amounts owed by **any** of the mortgagors as guarantors of FHI Group"

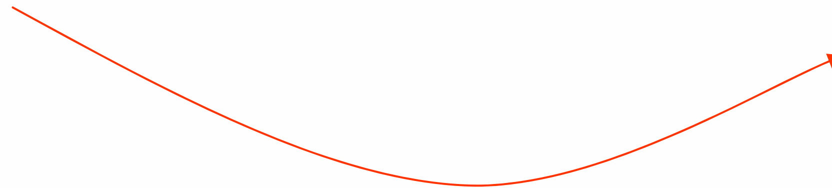
Mercantile Mutual Life Insurance Co Ltd v Gosper

(1991) 25 NSWLR 32 (NSWCA)

Mr & Mrs Gosper

Mortgage $265,000

Mercantile Mutual
Registered mortgage



Variation of mortgage

Variation of mortgage $550,000
Mr G signed variation and forged
Mrs G's signature

Mercantile Mutual
Registered variation

PT Ltd v Maradona

(1992) 25 NSWLR 643

Mrs Thompson

Registered proprietor

Mortgage and guarantee void – successful plea of *non est factum*

EMF NV

Registered mortgage

transfer of mortgage

EMF PV

Registered mortgage

PT Ltd v Maradona

(1992) 25 NSWLR 643

"moneys hereby secured" – moneys owing by the mortgagor or moneys owing by any "other indebted person" – any person jointly or severally liable with the mortgagor

Chandra v Perpetual Trustees Victoria

(2007) 13 BPR 24,675

- The mortgage is security for payment to us of the secured money …
- “Secured money” – all amounts that are payable at any time or are contingently owing or payable to us under a secured agreement
- “Secured agreement” any present or future agreement between us and you or any of you …

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Indefeasibility and All Advances Mortgages: Are they a thing of the past?

Michael Robinson
Partner
Simpson Grierson
Auckland

Indefeasibility and All Advances Mortgages:

Are they a thing of the past?

Michael Robinson
Partner

Simpson Grierson

Westpac v Clark: The Facts - 1

- Mrs Fenech owned an unencumbered land in Auckland
- A fraudster obtained a false passport in Mrs Fenech’s name
- The fraudster arranged a loan to be secured against “her” property
- Standard “all obligations” mortgage and loan documentation

Simpson Grierson

Westpac v Clark: The Facts - 2

- Bank instructed fraudster's lawyer to arrange execution and registration of documents
- Solicitor certified documents executed, and undertook to register mortgage "promptly"
- Drawdown → Default
- Bank had notice of fraud – notified *Land Information NZ*
- Solicitor's delayed attempt to register mortgage unsuccessful

High Court

- Bank sought summary judgment on undertaking to register "promptly"
- HC accepted that "prompt" registration:

  ⟶ Indefeasible mortgage
- But trial to consider:
  - lending decision/enforcement

Court of Appeal

- Short shrift to these “defences”
- But raised question “indefeasibility for what?”
- An “intriguing” academic issue comes to be decided

Documents - 1

Mortgage

- “*In consideration of the “secured money”, **you** as Mortgagor, hereby mortgage to the mortgagee all of **your** estate and interest in the land*…”

Memorandum of Mortgage

- Secured money: “*All money which **you** … may owe to Westpac now or in the future*…”

Documents - 2

Payment:

- "***You*** *must pay to Westpac, on time, the Secured Money.* ***You*** *must pay the Secured Money on demand except where* ***your*** *Loan Agreement or another Bank Document provides otherwise* …"

- Several other references to payments or obligations under "**your**" Loan Agreement.

Accepted principles

- Registration protects the charge, but doesn't validate forged covenant to pay
- Registration gives mortgagee recourse to the land
- If a fixed sum mortgage, the advance would be secured
- Statutory compensation would be available to discharge the mortgage

Substance in the forms?

- Fixed sum/all advances both statutory forms
- Statute contemplates mortgage securing future advances
- Under both scenarios:
  - No monies advanced to "you"
  - No personal covenant owed by "you"
  - Need to go beyond registered documents to identify secured debt
- Consistent compensation regime

Supreme Court

- Unregistered covenant *could* be incorporated, but only if documents *must* be incorporated that way
- Westpac never *intended* taking security from anyone other than named mortgagor
- "You" ≠ "you"
- Strict contractual interpretation, uninfluenced by policy/scheme of Act

Solutions?

- An industry issue requiring industry response
- Drafting solutions – “bold” and “unappealing” (but so is indefeasibility?)
- Return to fixed sum mortgages? Commercial challenges
- Review identification practices and relationships with solicitors
- Statutory law reform
- Title insurance

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Saturday 1 August
3:00pm – 4:30pm

The Credit Crunch - Lessons for Lawyers

Chair:
Nuncio D'Angelo
Partner, Mallesons Stephen Jaques, Sydney

Speakers:
Ian Greer
Managing Director, Standard & Poor's, Sydney

Tim L'Estrange
Group General Manager, Governance, ANZ Banking Group, Melbourne

Bill Moss
Chairman & Founder, Moss Capital, and Chairman, PBB Advisory, Sydney

Michael Pelly
Legal Affairs Journalist, The Australian, Sydney

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The Credit Crunch - Lessons for Lawyers

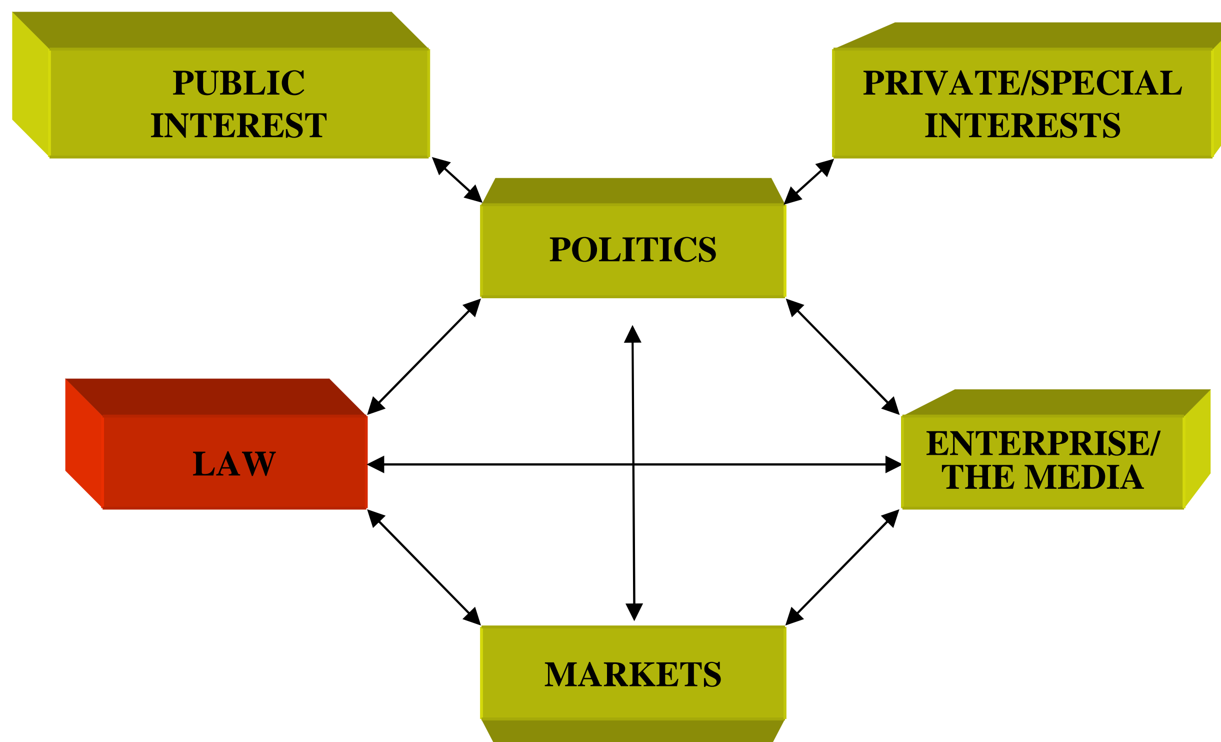
Nuncio D'Angelo
Partner
Mallesons Stephen Jaques
Sydney

BFSLA Annual Conference 2009
"The Credit Crunch - Lessons for Lawyers"

Date:	3.00pm, Saturday, 1 August 2009
Chair:	Nuncio D'Angelo, Mallesons Stephen Jaques
Speakers:	Ian Greer, Managing Director, Standard & Poor's
	Tim L'Estrange, Group General Manager, Governance, ANZ
	Michael Pelly, Legal Affairs Journalist, The Australian

"The Credit Crunch - Lessons for Lawyers"
The law and lawyers in the grand scheme

Professor Geoffrey Miller of New York University School of Law* has described the inherent linkages and cause-effect relationships between the main systems in our economy, as follows:



Actions in any of these boxes tends to lead to responses and reactions in linked boxes.

* *Stuyvesant P. Comfort Professor of Law Director, Center for the Study of Central Banks and Financial Institutions*

“The Credit Crunch - Lessons for Lawyers”
Questions for discussion

1. What could or should lawyers have done? What was our role? What did we *think* was our role? What happened to our “trusted advisor” role? Were the roles of in-house and external lawyers different? Did we have a broader role, eg risk manager, public interest, whistleblower, educator, canary in the coal mine?

2. Did we have conflicting (commercial) interests, ie vigilance vs alignment with client’s commercial drivers, not wanting to upset or slow the deal? Did we allow our role to be subordinated to become mere transaction facilitators, just “papering the deal”?

3. What will banking/finance look like in the next few years?

4. How should lawyers’ role change to deal with these issues in the next boom? What do we do to help effect that change?

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